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Private Equity – Financing the North Sea

Although there has been a slowdown in oilfield services (**OFS**) M&A activity there is a general consensus that there continues to be a healthy appetite for quality assets at the right price.

A large amount of private equity money has already been raised and is looking for a home in the OFS sector despite the challenges of $60 oil. We have seen banks continue to be flexible and this together with longer term equity commitments from private equity has perhaps meant that those businesses with cash flow issues have fared better than expected and we have not yet seen the volume of distressed situations previously predicted.

Mark Kerr, a director at LDC, agrees that PE appetite remains '*especially from knowledgeable investors with a history of investing in the sector. These investors understand the cyclical nature of the market and appreciate that there are still excellent opportunities in certain niches and geographic markets. Certainly at LDC we see it as a good time to invest selectively in the sector*' he says.

Investors are continuing to introduce experienced non-executive directors to provide strategic direction throughout a more challenging economic environment and provide access to new networks of potential suppliers/customers through their investment portfolios. Follow-on equity funding rounds are also being completed with investors projecting a return to more stable market conditions - demonstrating the risk/reward culture of private equity and their appetite to allow their investee companies to unlock their growth potential over the longer term. Now, more than ever, we are seeing the significant benefits of the strong relationship between management and private equity.

Private Equity investors are still keen to invest but it seems there are two key considerations:

1. the price has to be right - no one is going to overpay in the current market but equally sellers are reluctant to exit cheaply so commercially vendor and investor/buyer price expectations need to converge; and
2. the assets have to be good quality as credit committees are unlikely to back investment into assets with contractual or compliance issues.

Graham Alexander, Corporate Finance Partner and Head of Oil & Gas at Johnston Carmichael, concurs that those PE investors with knowledge and experience of the OFS sector are continuing to actively pursue opportunities and regard the current market conditions as favourable to those that can 'buy well'. '*We see activity levels for PE investors holding up and deals being completed where investors, vendors and advisers are willing to reflect realistic pricing and deal structure expectations. The focus on the nature and quality of earnings is key with businesses with more Opex related operations being more favoured vs. those exposed to larger Capex related project work. An increasingly important differentiator is the strength and experience of management teams, with those that have had experience of the cyclical nature of oil & gas in the past generally being better placed to manage trading through these more challenging conditions and present opportunities for investment*.'

Being a good quality asset and maintaining price

To become or maintain a position as a quality asset a business has to be able to withstand investor/buy-side due diligence investigations. Management teams need to create and further enhance value by finding ways of doing things better, smarter and by presenting a cleaner shop to potential private equity investors. Then, if they are involved in any exit event or a funding process, management can justify and maintain the offered price and minimise the chances of there being any claim after the event.

A bit of work upfront by management working with their lawyers and experienced OFS Corporate Finance advisers pays off. Using adviser experience of not only the sector but previous cycles should make any bid/investment terms more concrete and it should cut time out of any transaction through anticipating/resolving any issues which might arise as part of any process and providing information to the investors to allow them to satisfy themselves.

On the legal side it pays dividends to use lawyers with specific expertise within the oil and gas sector to try and streamline any data site/due diligence and warranty process so that the business can robustly withstand questioning from the investor/buy side experts and defend any challenge to the offered price. Being able to project a clean and robust picture also demonstrates that a high level of process management is already in place and will not require the cost to put in place post-completion which is something that investors will find appealing.

Management teams with their legal advisers need to start thinking ahead of any process about what type of questions they will be asked. For example:

- What are your contractual blind spots/biggest areas of exposure?
- Do you have a consistent policy and process for agreeing contractual terms? How does the business operate its liability and indemnity regime?
- Termination of customer/supplier contracts – when, how and why?
- Are there gaps in any insurance cover which deal with risk under the contracts/how are legacy risks insured?
- How do you manage and ensure bribery and sanctions compliance within the business?

Don't get sued

Specialist lawyers who understand the sector are also invaluable when it comes to negotiating the transaction. Management teams need to provide a level of comfort to investors/buyers but that level of comfort has to be right and appropriate to the OFS sector.

Warranty and indemnity (**W&I)** insurance is becoming an increasingly regular feature of the M&A landscape and is frequently used as a mechanism to fill the gap between the protection the buyer/private equity requires in the share purchase agreement and the protection that vendors/management are willing to give. It is either being stapled to offers on the buy-side or incorporated into vendor term sheets as an expectation that the buyer will top-up the vendor protection being offered through insurance. In recent years, underwriters have recognised that a sensible approach to claims is important as a way of building confidence in the W&I product. Anecdotal evidence suggests that claims are more frequent where W&I insurance is in place than under uninsured warranties and insurers recognise this as a feature of the market.

This is the fifth Foresight article in our Transformation series looking at the future of North Sea Oil and Gas. Discussing various issues from technology to employment and disputes, our sector experts offer their commercial opinions on the future of the industry. Please feel free to forward this Foresight to a colleague or to subscribe to our mailing list here CMSEmployment.Team@cms-cmck.com.

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