

PRIVATE EQUITY INVESTMENT IN AFRICA'S OIL AND GAS (O&G) INDUSTRY – WHERE TO NOW?



Simon Tysoe, Partner,
Latham & Watkins'
London



Clement Fondufe,
Partner, Latham &
Watkins' London



Evelyne Girio, Senior
Associate, Latham &
Watkins' London

As Africa's economy has grown in recent years, we have seen a high degree of private equity (PE) activity across African industries. Between 2013 and 2018, African PE fundraising reached US\$17.8bn, the total value of reported African PE deals reached US\$25.7bn¹ and the total number of reported deals was 1022. Total deal volume rose by around 9% last year and many of the 186 reported African PE deals in 2018 were consumer-focused.² Similar deal activity is not as apparent in the African energy sector, which in the period 2013 to 2018, accounted for just 3% of all African PE deals by volume and only, but a significant 14% of all African PE deals by value.³

Even though PE is no stranger to the energy sector, its focus has for the most part been on North America, where the majority of energy-focused funds continue to seek investment opportunities. PE's interest in the sector has become more global in recent years and it has been reported that PE invested US\$12bn in the North Sea between 2015 and 2017,⁴ though this was less than PE investment of US\$19.8bn in US shale in Q1 2017.⁵ Nonetheless, a high proportion of the most significant energy deals in the last 5 years has involved PE funds or their portfolio companies. In 2015, Helios and Vitol acquired 60% of the economic rights and 51% of the voting rights in Oando's downstream business for US\$276mn and, in 2016, Helios acquired 49% of the voting rights in Oando's, gas supply business subsidiary, Oando Gas and Power, for US\$115.8mn. In 2017, Assala Energy, backed by The Carlyle Group, acquired Shell's onshore assets in Gabon for US\$628mn and, Trident Energy, backed by Warburg Pincus, in partnership with Kosmos Energy, each acquired a 50% stake in Hess's interests offshore Equatorial Guinea for US\$650mn. In October 2018, a consortium led by Vitol and comprising Delonex and Africa Oil Corporation acquired Petrobras' entire 50% stake in Petrobras Oil and Gas, a company with Nigerian

production assets for US\$1.407bn. Helios and BTG Pactual hold the remaining 50% stake in Petrobras Oil and Gas which they acquired from Petrobras in 2013 for US\$1.5bn.

The fact remains that outside of the US PE investment into energy remains the preserve of funds and portfolio companies equipped to deal with a market that presents different challenges. The common feature in the recent spate of such PE investment activity is that it has almost exclusively originated from buy-out groups with significant industry expertise. Warburg Pincus has been investing in the global energy space since the 1980s and has invested or committed over US\$14bn across over 90 energy-related companies. Similarly, Kosmos, backed by Warburg Pincus and Blackstone, is one of the most successful oil companies of recent years.

PE funds are ultimately dependent on the risk appetite of their investors and in this perception is key. Concerns over regulatory and fiscal uncertainty, lack of transparency and political and economic instability, whether real or imagined, shape many investors' view of African O&G. In addition, investment in the O&G sector frequently involves partnering with the host State, heightening potential exposure to the Foreign Corrupt Practices Act. All of this drives a concentration of investment into funds perceived to have the experience to handle this. In turn, funds exercise great scrutiny over the management teams they invest in and, for certain deals, may partner with O&G companies other than their own portfolio companies in order to leverage local knowledge and relationships or expertise in technical operatorship.

Local issues also shape the sort of assets that are attractive to PE. The infrastructure deficit in Africa means that production assets can be isolated due to lack of transportation, especially onshore,

1. AVCA, 2018 Annual African Private Equity Data Tracker with Regional Spotlights.

2. Ibid.

3. Ibid.

4. FT, "Private equity leads the changing of the North Sea guard", 13 February 2019.

5. Prequin report as reported in Reuters "Undaunted by oil bust, financiers pour billions into US shale", 17 April 2017.

leading to a preference for assets located offshore or near existing infrastructure. Of course, the opportunity to invest in such infrastructure is an area in which PE is looking to deploy capital but, typically, these deals involve the acquisition of existing infrastructure plus perhaps brownfield development. The greenfield development of large pipeline infrastructure, especially in non-OECD countries, tends to pose risks outside of and has a timeline inconsistent with, the requirement of most PE houses.

Local currency issues are also problematic. Whilst oil export projects have dollar-denominated offshore cash-flows, many gas projects have significant domestic elements, especially where gas-to-power is involved, meaning investors would have to factor in potentially costly long-term hedging (if available). There is significant interest in building the environment in which infrastructure projects and gas-to-power projects can be established in Africa, and the vocal support of organisations such as OPIC and IFC is very welcome, but in the short-term, the historic preference will likely continue.

Another constraint is the appetite of lenders to provide the leverage PE funds need to optimise their returns. The range of banks offering acquisition finance on African upstream O&G deals, which typically rely on reserve-based lending techniques to size the debt, is more limited. The risk level inherent to O&G lending in Africa can dampen many banks' appetite for lending and leading these deals has become the preserve of a handful of specialist bank teams. Alternatives are sometimes available. Credit funds may offer liquidity but they typically do so at rates which are unattractive for PE investors, certainly as a complete alternative to traditional debt, although they may well participate in a tranche to make up a short-term financing gap. Occasionally, local bank participation is viable, although capacity is constrained for USD loans and even where funding is available the terms are often unattractive. A more viable long-term option might be oil traders with extensive industry knowledge such as Vitol, Glencore, Trafigura and Mercuria, which are more willing to take on the risks inherent to O&G deals in Africa, in exchange for obtaining access to future production at a locked-in price using a pre-payment finance model. They might even be persuaded to invest equity as well. This model has also been adopted by the trading arms of large oil companies such as Shell and BP. However, pre-payment financing is technically optimised for assets already producing oil, whereas exploration assets or those with largely gas output are not suited to it.

The most important factor that PE funds weigh before investing is the viability of exit. PE investors need to secure an exit, whether via a sale to a strategic, a secondary buy-out or a public market exit through an IPO. Since O&G is a cyclical business, careful timing of exits to coincide with favourable markets is necessary. Specialist funds anticipate the need for flexibility and, whilst general buyout funds typically hold their investments for about three to five years, investment horizons for African O&G are typically longer. A preferred exit for PE houses and management teams alike is an IPO. Notwithstanding the infancy of capital markets in Africa, we saw numerous successful IPOs by exploration and production companies outside Africa from 2000 to 2015 when exploration-focused companies found favour. To name but three: Africa Oil Corporation backed by Helios Investment Partners, listed in Toronto and Stockholm in 2007, Ophir Energy, backed by Och Ziff, listed in London in 2011. Similarly, Kosmos, which was initially backed by Warburg Pincus, began trading on the NYSE in 2011. However, since oil price correction in 2014 the IPO markets, especially in London, have not been welcoming to O&G debutantes. Vivo Energy's IPO (backed by Vitol and Helios) on the LSE in April 2018 was the first noteworthy float of an energy-focused company since Seplat (a Nigerian O&G group) raised US\$500mn in 2014, and notably marks a shift away from exploration-focused businesses to the downstream, where risks are less and the promise of rising African consumer demand helps the equity story.

Sales to other PE or to strategic buyers can offer a route out, although many of the upstream assets being disposed of are sold by oil majors so the likelihood of acquisition by a strategic is limited unless that strategic is either locally based (e.g. a Seplat) or focussed on late-life assets. Given the uncertainty of exit, many PE investments in the upstream O&G space are calculated to return investment through dividends during the life of the investment with a more conservative value on the exit, a very different approach to the traditional O&G exploration model.

In conclusion, the last five years have seen significant PE activity in African O&G, but this activity has been focused on certain highly experienced funds and portfolio companies looking at certain asset types. The developments that will facilitate greater PE investment are the same developments that will benefit O&G development in Africa more generally – greater infrastructure development, greater local banking capacity, increased transparency and a consequent change in risk perception.