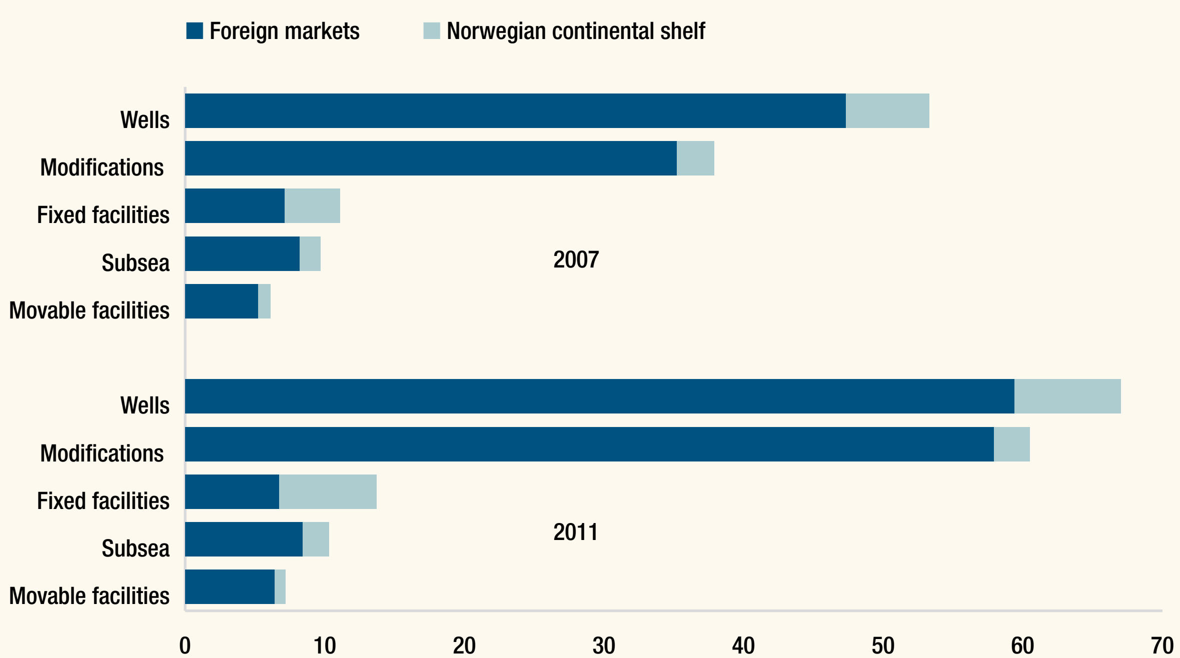
Private equity in the Norwegian Petroleum Industry

The Norwegian economy is strongly dominated by the offshore petroleum industry. 30 percent of Norway's GDP is generated here and more than half of export revenues come from oil- and gas- related activities. The share has been growing over a long time, although oil production in Norway started falling as early as 2000. Income growth is now a result of successful expansion in international markets, and every now and then higher oil and gas prices. The international expansion is not primarily driven by Norwegian oil companies, but rather by the industry that surrounds such companies. Firms that develop and design new oil rigs play an important role. So do companies that develop subsea technologies, new and more efficient drilling techniques, ways to identify new oil and gas fields (e.g. seismic services), firms that provide management, modification and operational services (MMOs), and not least companies that improve the environmental quality of drilling for oil offshore.

The 2008 MENON petroleum sector internationalization report shows that the offshore petroleum industry is focusing just as much abroad as at home. From 2005 to 2007, revenues in international markets doubled and have quadrupled over the last ten years. Planned and expected investments show that offshore activities will continue to grow over the coming years, but predominantly in foreign markets. The fact that the Norwegian offshore industry

Figur 3.1: Investments in 2007 and expected offshoreinvestments in 2011 within the largest segments bill. USD



Note: Most important market segments on the Norwegian continental shelf and in the rest of the world in 2007 and 2011. Source: INTSOK/Infield 2007

Norwegian private equity funds focusing on the petroleum sector:

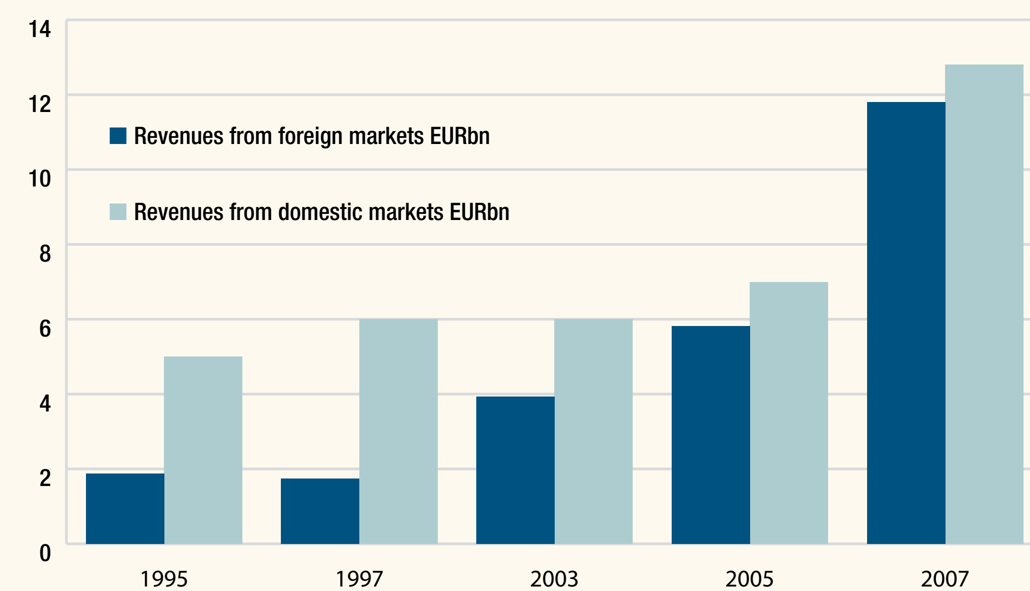
HitecwVision manages approximately EUR 0.9bn in three funds, almost exclusively focusing on the petroleum industry within the expansion and buyout segment. The company is located in Stavanger, with offices in Aberdeen and Houston. Energy Ventures manages approximately EUR 250mill. in three funds, with a stronger focus on the venture segment. Energy Ventures is also located in Stavanger, Aberdeen and Houston, and like Hitec Vision, a large share of its portfolio is located outside of Norway.

The generalist buyout funds Herkules Capital, Reiten & Co, Norvestor, Progressus and Borea Opportunity have all made large, but relatively few single case investments in the petroleum sector. Their case-by-case focus on the petroleum sector indicates that several management teams in late stage funds have industry-relevant knowledge. Last year, Herkules Capital closed one of the largest deals in the sector so far, taking over majority ownership of the oil service company Aibel.

Generalist venture capital funds in Norway are not focusing to any great extent on the petroleum sector. Ferd Venture is deeply involved in the sector indirectly through ownership in Energy Ventures. Viking Venture and Verdane Capital are also represented with selected investments.

The number of seed and early start-up investments in the private equity / VC industry is also limited, and there are no players focusing solely on the offshore industry. Large corporate venture players like Energy Capital Management (previously Statoil Innovation and Hydro Technology Ventures), and SINTEF/Sinvent have initiated a series of ventures based on their own internal activities, and this may have contributed to capping the number of offshore investments among other early stage funds. Among those who do invest, we find Stavanger-based Procom Venture and SåkorninVest funds with close ties to the industry in the region. In the science and technology focused Trondheim region, the new fund Proventure Seed has turned serious attention to the industry. Also, in the booming subsea industrial cluster of Agder, Skagerak Venture Capital has invested in some rather successful offshore related startups.

Figur 3.2: Domestic and foreign revenues



Source: MENON Business Economics 2008

shows a strong ability to serve these markets gives grounds for optimism.

It is also among this kind of firms that you find Norwegian private equity investments. According to the MENON private equity database, Norwegian funds have invested in 124 firms in the petroleum sector since the late nineties. So approximately one out of five Norwegian private equity investments is placed in this industry. In our opinion, this is a fairly low number, considering extremely high returns compared with other sectors. Historical figures show that IRR among funds focusing on this segment often climb above 30 percent. In Figure 3.3, we report the number of investments in the sector according to segment. The number of early stage investments is surprisingly low compared with the more mature segments. So why is the number of investments, and especially in the earlier stages, not larger?

There are several explanations. First of all, the petroleum industry is believed to be driven by cyclical factors. The private equity model does not fit well into a business context where volatile and unpredictable fuel prices determine returns on investment. However, as described above, 80 percent of private equity investments in this sector are focusing on services and products that supply and interact with the oil companies (E&Ps), and not the E&Ps themselves. Such firms are much less vulnerable to oil price fluctuations. Pål Reed in Hitec Vision gives one example: "If you invest in a company specializing in Surface maintenance and painting, contracts often last for ten years and more. Then, you easily cut through the price cycle."

Second, many investors think of the Norwegian petroleum sector as a shrinking venture. Yet, as shown above, those firms that previously served the Norwegian industry are now grabbing market shares in foreign offshore petroleum markets. International growth during the past five years has been impressive, and will according to investment plans continue to show strength over the next years. We asked Mr. Reed why the Norwegian funds are not focusing more on investment opportunities in the Far- and Middle Eastern regions, where expansion is expected to be particularly pronounced. "I think that it has a lot to do with proximity to management and the business environment. We have invested in several firms operating worldwide, but their headquarters are mostly placed where we are located. Our strong local presence gives us an exclusive dealflow which we cannot expect to find in these regions. Having said that, the trend of moving towards these regions is gradually getting stronger. A good illustration is the relocation of Haliburton to the Middle East."

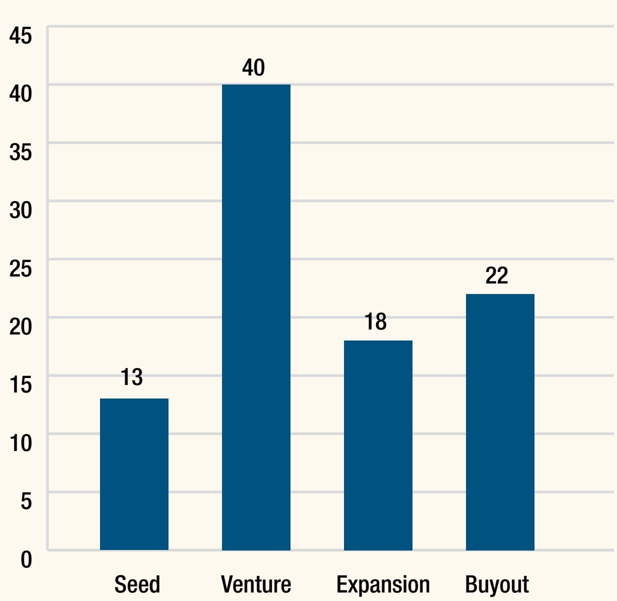
Third, due to high returns on investment in this sector, capital is really not a scarce factor. Consequently, relatively immature firms are offered debt or equity financing with few strings attached. This may affect the willingness to bring in private equity in the early stages. The entrepreneur is often reluctant to leave control in the hands of external owners with tough term sheets.

Fourth, it is relatively complicated to enter the business environment in the Norwegian petroleum industry (and especially in Stavanger). There are local club tendencies between managers, and decisions are often made in close networks based on personal ties and similar business cultures. E.g., the more formal and "finance styled" business culture in the larger European buyout funds may not always fit perfectly with the offshore entrepreneurial culture in the western part of Norway. We also know that several technology-focused venture funds have experienced problems getting a grip on the business model in this sector. These funds are especially interested in clean tech ventures relating to petroleum extraction. Compared to other clean tech ventures, the petroleum related ones often have a shorter road towards commercial success.

In light of the impressive returns on PE investments in the Norwegian petroleum sector, several larger international funds have recently searched the sector intensively for investment opportunities, without any particular success. So the problem for investors in private equity is to identify funds that are actually able to complete investments in the industry. When they are inside, returns are likely to be quite satisfactory.

When asked about future prospects, Mr Reed points to some central aspects of the offshore industry: "It is the only sector in Norway with a large international management pool to work with. It is the only industry where firms are represented in the whole value chain. Moreover, the industry has shown an impressive ability to grow internationally. When you add the fact that most of the larger players (like Schlumberger, FMC, Kongsberg Group and General Electric) tend to expand through acquisitions, the potential for future profitable PE investments is no worse than before." We would also like to add that although oil prices have plummeted lately, long-term demand is expected to continue to climb with gradually shrinking supply. ■

Figur 3.3: Number of investments in the petroleum sector (1997–2008)



Note: In 31 investment cases, the segment is unknown
Source: MENON Business Economics 2008

Some representative investments:

Aibel	Oil services (MMO)	Large buyout case - Not exited
APL	Loading equipment	Exited - IPO
Revus Energy	Exploration and Production	Exited – IPO
MTEM	Seismic Services	Exited – sold to Petroleum Geo Services
Add Energy	Oil Services	Buy and build case – Not exited
PSI	Pipeline plugs and installation	Exited – sold to T. D. Williamson
Ziebel	Well operations and diagnostics	Expansion case – Not exited