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Midstream Indies Seize Opportunities

Plenty of startup midstream companies are expected to come out of the gate in coming years, and there's good reason for it.

By Michelle Thompson

Bigger doesn't always mean better. Just ask some of the new, private-equity funded midstream companies emerging in the sector. They're capitalizing on the abundance of advantages small startups have above the public midstream giants, which largely dominate the space.

Take EagleClaw Midstream Services LLC, for instance. The newly formed company is among a handful of midstream startups formed in the past year. Many are backed with private-equity commitments. And in an industry where timing is everything, smaller independent companies can begin projects faster, claim first-mover advantage and work more intimately with clients.

As many as a dozen new privately funded midstream startups could emerge in coming years thanks to a $1.75 billion institutional equity fund recently closed by EnCap Flatrock Midstream LLC. EnCap Flatrock Midstream Fund II exists to financially support midstream startups. It's anticipated that EnCap Flatrock could use the fund to back between eight to 12 management teams. It intends to source and start up those companies over the next few years, though actual project realizations will not occur for at least another three to five years.

Meantime, a new midstream company emerged September 5 thanks to up to $500 million in equity commitments from Riverstone Holdings LLC and Kaiser Midstream. The funds helped form Sage Midstream LLC, a new natural gas liquids company.

Sage joins the ranks of several startups that have emerged recently including, of course, EagleClaw.

Formed in July 2012 with a $100 million equity commitment from EnCap Flatrock's Fund II, EagleClaw will serve the midstream infrastructure needs of Permian producers. The Midland, Texas-based company will focus on placing midstream assets in reservoirs where such infrastructure doesn't yet exist. It will provide natural gas gathering lines and cryogenic processing facilities, as well as gas treating and field compression services.

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Lucid Energy Group sees the advantage of decisive action, too. It can put privately funded companies a step ahead of their public counterparts, which usually only move rapidly during aggressive growth cycles.

"There's always a period in the lifecycle of larger companies where they get comfortable," says Mike Latchem, Lucid's chief executive.

"A private company doesn't have any choice but to make decisions and execute quickly. If we continue to act with determination and a sense of urgency, we can find opportunities to move a little quicker around those companies that are in that comfortable stage."

Lucid formed in January 2012 with a $75 million equity commitment from EnCap Flatrock's Fund I. Lucid plans to provide a host of midstream services, including

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oil and natural gas gathering, gas compression, treating, processing and transmission. It plans to pursue greenfield initiatives and acquisitions in both conventional and unconventional U.S. resource basins, focusing largely in the producing regions of Texas and Oklahoma.

When Lucid begins establishing a presence in some of those plays, it will take an organic approach to growth, which will allow it to offer customized solutions and services to customers. That's crucial in an industry where requirements differ from basin to basin. Some areas might require gas gathering services, while others could be seeking gas processing.

"Our advantage as a private company is the flexibility to tailor-make solutions for our customers instead of just trying to replicate what's been done over and over again," says Latchem. "Starting from scratch and having private-equity backing is really where we employ that private advantage, versus competing with a lot of the public companies and MLPs [master limited partnerships], which have a cheaper cost of capital in acquisitions and

"There's a lot of new drilling and production that's just now being completed in the Permian Basin, and we're seeing these reserves come up in areas where there's never been drilling before. There's no midstream infrastructure," says EagleClaw President Bob Milam.

"Someone is going to have to build midstream infrastructure. This production is in areas that are all brand new. We see a lot of opportunities to provide services for producers on a personalized basis and at a quicker response time than some of the major midstream companies will be able to do."

Acting fast

Decision making for midstream's major players can get bogged down by layers of bureaucracy. Smaller companies, meanwhile, can act much faster since the decision chain is significantly shorter. That time advantage gives smaller companies an upper hand in their ability to respond quicker and more personally to producer's needs, says Milam.

development. We see organic growth as the most effective way to deploy private equity funds, both for our customers and our investors."

Many believe that private-equity support allows companies to take more risks, but Latchem says that's not always the case. What is most important, he says, is that such companies have more flexibility in terms of when they start bringing in revenue. While public companies may be under pressure to produce strong financial results as soon as possible, private companies are able to delay revenue and devote money to developing physical assets without the need to produce an immediate, guaranteed revenue stream.

"This is a tremendous advantage," says Latchem.

Risky business

Of course, when companies like Lucid enter plays, it's sometimes difficult to predict how productive they'll be. Companies find themselves walking a tightrope of catching the first-mover advantage, while proceeding with caution. Being too aggressive can result in companies making bad investments.

"There's a delicate balance," says Latchem. "There's a lot of risk in putting infrastructure in place in emerging plays until there's proof of concept. We're very cautious about how we put money to work, making sure we don't put too much risk capital out in the market, or build too much too soon."

When independent companies take risks by entering undeveloped or underdeveloped plays, they can ultimately benefit major public companies as well, says one of EnCap Flatrock's three managing partners, Billy Lemmons.

"Private-equity capital can get in at an earlier state and develop these emerging opportunities over the course of a couple of years," Lemmons says.

"When contracts have been put in place and the assets have been built, they can then turn those opportunities over and sell them to the larger players in midstream. Those larger players can come in with bigger management teams, larger balance sheets and develop those opportunity sets more fully."

Striking a balance

Meantime, Milam says he expects EagleClaw's biggest initial challenge to involve aggregating adequate volumes. Aggregating significant acreage dedications in an area helps ensure there is enough momentum to fuel financial success. To avoid "putting all the eggs in one basket," Milam believes two or three different deals with producers will be needed to anchor a project.

Starting a company from scratch can be easier when the founding members have worked together in the past. This is the case for EagleClaw. Its three founding partners—Milam, Curtis Clark and Charles Kuss—have known each other for years.

"I think this is a huge advantage," says Milam. "It leaves no unknowns. I know how these guys treat employees, I know how they treat customers, and I know how we've interacted. Together with the fact that we are a Midland-based company, I think that's an important differentiator to be able to take to the marketplace."

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Lucid's founding partners have a rich history too. They've worked together in the numerous producing basins in a variety of capacities. They formed Lucid with hopes of becoming more aggressive in the gathering and process business. Walking into the new company with existing relationships—both internally and externally—helped strengthen Lucid from the start, says Latchem.

"From the commercial and business-development side, it's very much a relationship-driven business," says Latchem. "Just from an enjoyment perspective, it's rewarding to be able to work with somebody that you know from years of existing relationships and put something together that's brand new."

Smart investing

EnCap Flatrock, the financial backer of EagleClaw and Lucid, says it strives to support the very best companies in the midstream sector. The company—led by managing partners Dennis Jaggi, Bill Waldrip and Lemmons—uses the principals' deep knowledge and decades of experience to drive investment decisions.

EnCap Flatrock helps form management teams that are respected, experienced and deeply ensconced in the industry. It likes to see such teams positioned in areas with compelling and strong supply-side economics. The firm also carefully examines the geology and technical aspects of every play to determine how producers might best develop them.

"Whether we're looking at a conventional or unconventional oil or natural gas play, our focus is looking at the economics of upstream development in an area," says Waldrip.

"We're looking for areas that have the strongest economics for upstream development because we're looking at putting our midstream dollars to work in areas where significant growth is going to occur. We believe fundamentally that those areas where midstream growth is going to take place are always the areas that have the best economics from an upstream perspective. That's where we are looking to invest."

Despite EnCap Flatrock's decision-making strengths, it knows there are risks. The unsteady commodity-pricing environment makes it difficult to predict how development might ultimately play out over a certain period. As oil and gas prices rise and fall, producers are forced to modify their plans to adjust to those changes. Flexibility is key for its teams and the facilities they build. Because midstream is a service-oriented business, the obligation is on gatherers and processers to meet customer demand, even in times of trouble.

"The intricacies of the business are pretty complex," adds Lemmons. "You've got to have some flexibility in working with the producer-customers as to where they're focused and how their plans change. As opportunities develop, it's really our job to pick good teams who really know the intricacies of the business and who can execute those opportunities successfully."

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EnCap Flatrock has indicated to EagleClaw and Lucid that it would consider increasing its financial commitments if the startups require additional funds as the businesses grows. EagleClaw believes the equity commitment they have already received will stretch far, given the plays they are operating in. EagleClaw, for example, is focused in the Permian Basin which is significantly less expensive to operate in than other plays, like the Marcellus.

"Companies in the Marcellus are spending more because of the topography, land and labor costs, permitting expenses and the challenge of getting pipe in the ground in such a harsh environment," says Milam. "Our capital goes a little further than capital goes in those areas. The people of Texas are used to the oil and gas industry. We have a business-friendly climate that makes it easier to get things done quickly without sacrificing the quality of the project and with limited impact."

Milam says he's looking forward to putting his team to work. "We're excited about the Permian Basin. We're seeing a lot of opportunities, and we're ready to put our capital commitments to work." ■

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