

Global Leveraged Finance

Our perspective on high yield energy credit

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The recent oil price recovery is resulting in the emergence of select opportunities within the energy sector

After bottoming in late January, crude oil prices have rallied more than 50% as supply/demand dynamics have improved and rebalancing in the second half of the year has become consensus. In sympathy with this move in oil, virtually every high yield ('HY') energy credit under coverage has rallied meaningfully, with exploration and production ('E&P'), master limited partnerships ('MLPs') and oilfield services bonds alike up c.10–25 plus points from the lows tested in late January/early February.

While certainly driven by improving oil market fundamentals, the price action was exacerbated by technical factors, most notably a sizeable majority of real money accounts who were underweight energy (ourselves included) and not positioned for such a rapid recovery in the oil price. We have been selectively increasing our exposure to the space in our long-only and absolute return strategies since February. We felt that our level of conservatism heading into the year has become less warranted given the improving sector fundamentals.

Unfortunately we have found this move a daunting task as a result of stretched valuations and limited liquidity. In our view, fewer and fewer names offer a decent risk-reward following the meaningful correction we have witnessed in crude oil prices. For example, within the E&P space, the majority of names that have good liquidity, a sustainable (albeit in many cases still very stretched) capital structure and an asset base that generates economic returns now generally only offer mid-single-digit yields.

In our view, the backdrop in the MLP space is not much better with many names in similar yield territory facing organic volume declines as a result of decreased activity in certain bases and/or having exposure to customers with a greater than 50% chance of filing for bankruptcy protection over the next year. As a general rule of thumb, in order to find more meaningful yields/price convexity one is forced to dip into names that have some combination of:

1. Asset bases that do not generate full cycle economics at the current commodity price range
2. Unsustainable capital structures
3. Near-medium term liquidity events
4. A potential bankruptcy filing on the horizon. These credits will likely feature bond recoveries well below current levels should oil and natural gas prices remain at or below around US\$45 to US\$50 a barrel.

In essence, the matrix of investment opportunities can be summarised as follows. They are either names that do not face business model/capital structure risks at current commodity prices, but have meaningful downside if prices retrace. This would necessarily imply lower recoveries in a bankruptcy situation or the risk of distressed exchanges at depressed prices, and even the threat of further subordination within a capital structure through a priming (subordination) event. Or, they are names that offer significant upside, assuming a meaningful recovery in oil prices but, with some exceptions, recoveries are generally well below current prices assuming the commodity price range or worse transpires.

Our base case view is that long-term oil prices will likely trend higher from current levels, but that the near-to-medium term trajectory is more uncertain. While the overall narrative continues to improve, there remains a host of supply and demand side risks which could further postpone the improvement in oil balances and keep prices depressed for longer.

As we see valuations likely to remain correlated to overall oil prices—this is essentially true for all risk assets let alone E&P specific credit, we do not believe that earning close to market yields within the energy space is a good use of capital, given substantial asymmetry to the downside inherent in such valuations. Instead, we are focusing the lion's share of any new capital deployed to the space to either overlooked situations or more opportunistic stressed or event-driven situations, with double-digit internal rates of return ('IRRs') an investment pre-requisite.

In the E&P space, as discussed most credits offering such IRRs require higher oil prices to sustain operations under existing capital structures over the long term. Therefore we target companies in this category with meaningful liquidity cushions and comfortable covenant headroom that can operate in a depressed commodity price range for more than two years before facing a negative crystallising event. We have also been evaluating select opportunities within the oilfield services space, which has generally lagged the recovery we have seen in E&P and MLP valuations. Like our strategy within the E&P space, we target names with meaningful liquidity cushions or overlooked asset bases, which we feel can survive a prolonged commodity price downturn while offering considerable upside in a modest commodity price recovery.

We are fully cognisant of the meaningful downside risks to both E&P and servicers should oil prices retrace lower. These include liquidity/covenant events, priming/exchange risk and very likely low recoveries once a company files for chapter 11 bankruptcy protection. Servicers face the additional risk of existential business model threats as overcapacity and competition could squeeze out more levered players. As a result, we are both sizing investments to reflect such downside risk while targeting shorts in names with stretched valuations (in both equities and credit) that we believe will underperform in any commodity price retracement or have identifiable near-term negative catalysts.

Overall, we believe maintaining a prudent approach to this sector is appropriate where the future price of oil remains an unpredictable and very volatile variable.

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