

What can the Correction in Oil Mean for Energy Credits?

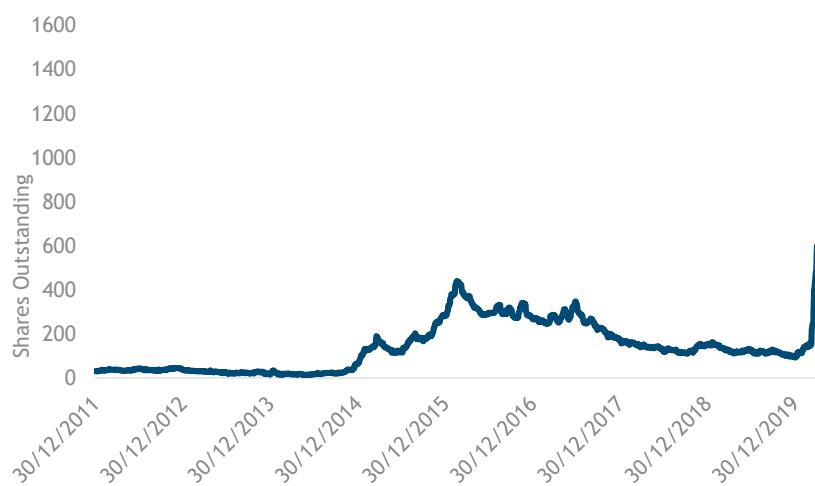
April 30, 2020

West Texas Intermediate (WTI) oil fell to a record low last week (week of April 20th)¹ as demand collapsed in the wake of the COVID-19 lock-down and the Saudi Arabia/Russia price war further exacerbated a supply/demand imbalance. In this brief note we will review the possible drivers of oil prices and what this could mean for energy credits.

What happened to oil futures?

Oil futures contracts (May WTI futures) fell to -\$37.63 on April 20, 2020² trading below zero for the first time ever. This price action appears to be rooted in fundamentals as supply has been slow to respond to a substantial drop in demand due to COVID-19 related global lockdowns. In certain regions, physical storage is reaching capacity. Financial imbalances also likely played a role as oil speculators and retail products such as USO oil ETF, created massive long positions as contract expiry approached (Figure 1 illustrates growth in shares outstanding of USO). Only one day prior to contract expiry, open interest in May WTI futures totaled approximately 109 mm barrels³, far exceeding the total physical oil storage working capacity of Cushing, Oklahoma which is approximately 76 mm barrels.⁴

Fig. 1 - USO oil ETF - Growth in Shares Outstanding



Source: Bloomberg USO ETF as of April 27, 2020. Provided for illustrative purposes only, not an offer or a recommendation to buy, sell or transact in any investments and should not be construed as investment advice.

Viewpoint



Clint Comeaux
Portfolio Manager

Clint joined Muzinich in 2006. He manages the Muzinich US High Yield strategy. Prior to joining Muzinich, Clint was a Research Analyst at WR Huff Asset Management. Previously, Clint was a Manager at Enron responsible for physical trading in the commodities group. Clint is a Chemical Engineer, formerly with PPG Industries. He earned a B.S. in Chemical Engineering, Summa Cum Laude, from Tulane University and an M.B.A. from New York University's Leonard N. Stern School of Business.



Carl DeMuth
Senior Energy Analyst

Carl joined Muzinich in 2018. He is a Senior Credit Analyst covering the Energy sector. Carl joins us from Goldman Sachs Asset Management where he spent six years as the Energy analyst. Prior to that, Carl spent eight years at Lord Abbett & Co. as a credit analyst covering the energy sector. Carl received a BAS degree in Mechanical Engineering from the University of Pennsylvania.

How did we get to this imbalance?

After decades of decline, the US oil industry experienced a renaissance in 2010 as hydrofracking drilling techniques (previously focused on natural gas production) were utilized to extract crude oil from shale deposits. US oil production grew annually by ~1mm bbl/day between 2011-15 gaining global market share along the way.⁵

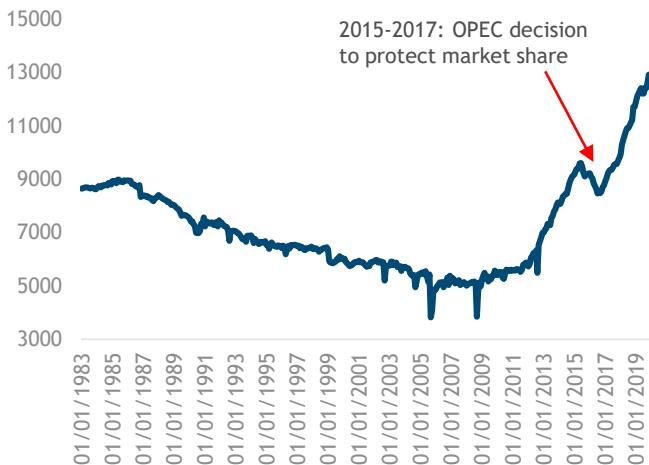
Fig. 2 - Global Oil Market Share

Market share	Feb 2012	Feb 2020
OPEC	35.3%	28.0%
Saudi Arabia	10.8%	9.9%
Russia	11.7%	11.5%
United States	7.1%	13.2%

Source: Bloomberg and Energy Intelligence Group as of February 29, 2012 and February 29, 2020.

OPEC's decision to protect market share gains from 2015-17, rather than price stability, temporarily halted the growth of US oil production. However, OPEC's actions had unintended consequences including pressuring the US oil industry to lower operating costs and improve technology, thus substantially lowering the cost of fracking. As OPEC joined with Russia in an attempt to control price in 2017, price stability returned, but so did the growth in US Shale oil production. (See Figure 3).

Fig. 3 - United States DOE Crude Oil Total Production



Source: Bloomberg United States DOE Crude Oil Total Production Index data as of March 31, 2020. Provided for illustrative purposes only, please see full index description at the end of this document.

When will oil markets return to some sustainable equilibrium?

The world is oversupplied with oil and the outlook for demand remains uncertain. We believe two developments are necessary to restore crude oil prices to levels that warrant economic reinvestment in energy exploration and development. First, demand needs to return to levels consistent with a globally functioning economy and secondly, production must be curtailed to levels that are consistent with the new norm of global demand.

Crude oil demand has suffered greatly from COVID-19 lockdowns, social isolation and the subsequent economic contraction. US airline passenger demand is estimated to have declined by 90% in April⁶ and global crude oil demand is estimated to have fallen by 30 mn barrels/day⁷. We believe that health concerns will persist long after lockdowns are lifted and the "new norm" for economic activity and travel may take 2-3 years to return to pre-COVID 19 levels.

Please read important references on page 3 of this document.

In the face of this outlook, we believe supply must contract. Supply side responses are happening - companies have announced reduced production and investment plans, Saudi Arabia and Russia announced planned production cuts and physical storage limitations may force well shut-ins. However, considering the magnitude of the demand contraction, in our view, the announcements thus far have not been enough to balance markets. We believe the supply side response will take some time to reflect the bleak demand reality due to the fragmented nature of the supplier base, varied sovereign interests, and decisions by individual company to operate for cash / liquidity needs.

What does this mean for US and global energy credits?

We expect US Shale oil production, which has grown rapidly in recent years, will contract and contribute to balancing global supply/demand imbalances. Low commodity prices and weak economic returns will likely reduce exploration and production investments. Contraction of the US Shale oil industry is expected to have negative implications for companies that lack scale, low-cost resources and financial flexibility to manage through the commodity cycle. Nonetheless, we expect US shale oil to remain a key supplier to global hydrocarbon demand given its sheer size, advantaged position on the cost curve, ability to flex up and down quickly to respond to demand and domicile in relatively stable sovereign.

Globally, we expect to observe the following:

- Lower drilling investment will likely drive fundamental weakness for drilling companies (offshore and onshore) due to low capacity utilization and price depreciation.
- High cost, highly leveraged companies will likely default. More than 25% of the US sub-investment grade energy companies defaulted in 2015/16 cycle.⁸
- Expect fallen angels. Ratings agencies will likely downgrade BBB/BBB- rated energy companies as they revise price forecasts lower.
- Survivors of this prolonged energy cycle will likely be low-cost, low-leveraged (mostly investment grade and higher rated BB) oil producers with financial flexibility to survive the cycle.
- Midstream companies (pipelines) and refineries should likely perform relatively well as these are volume driven rather than commodity price sensitive business models.
- Natural gas may experience counter cyclical upside as oil drilling activity declines (as much as 15-20% of US natural gas is generated as byproduct of oil production).⁹
- State-owned oil and gas companies will likely benefit from sovereign support due to strategic nature of the enterprise.

How might energy exposure be managed?

We learned several lessons from the energy commodity cycle in 2015/2016 that we believe can help guide how energy exposure may be managed through this correction.

We believe the most valuable lessons we learned from energy commodity cycle in 2015/16 are:

- Sell high cost oil and gas producers with liquidity constraints - recovery rates in energy defaults were below historical norms for non-energy defaults.¹⁰
- Avoid drilling services companies tied to exploration and production investment.
- Focus on low-cost producers, with strong liquidity profiles and dynamic management teams.

- Buy long-dated, high quality energy (including investment grade, fallen angels) in efforts to rebuild discount to par and participate in upside upon commodity normalization.
- Hold midstream companies but expect volatility as these bonds may trade with energy sentiment, but fundamentals tend to be less volatile.

Please do not hesitate to reach out for further insights.

Sources:

1. Bloomberg.
2. Bloomberg.
3. Open interest volume per Bloomberg on April 20, 2020.
4. Independent Statistics and Analysis U.S. Energy Information Administration (EIA) Working and Net Available Shell Storage Capacity November 2019 With Data as of September 30, 2019.
5. Bloomberg and US Energy Information Administration.
6. Source: TSA passenger data as of April 27, 2020. U.S. airline passenger demand is estimated by March and April Total Traveler Throughput
<https://www.tsa.gov/coronavirus/passenger-throughput>
7. US Energy Information Administration, Muzinich estimates as of April 17, 2020.
8. Muzinich analysis based on J.P. Morgan Default Monitor North America Credit Research April 1, 2020 and Bloomberg.
9. Bloomberg and Muzinich estimates as of December 31, 2019.
10. Muzinich observations confirmed by J.P. Morgan Default Monitor North America Credit Research April 1, 2020.

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United States DOE Crude Oil Total Production Data. This data is updated every Wednesday at 10:30 am for the previous week ending Friday. It is taken from text files released by the Energy Information Administration and is part of their weekly petroleum status report at <http://www.eia.gov/petroleum/supply/weekly>. Data in this weekly report is estimated. Current data estimates are based on weekly data collected by the DOE. Previous year data shown on EIA's website is based on Petroleum Supply Annual & Petroleum Supply Monthly and is not based on these weekly estimates. Previous year data is likely to be different from the weekly estimate for the same period, but this is not considered a revision of the weekly estimate.

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