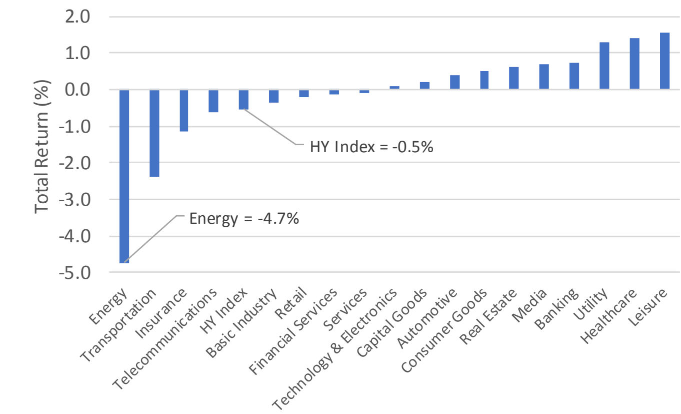
Mike Salice, CFA
Director of Research
msalice@skyhcm.com
January 21, 2019

Weekly Briefing

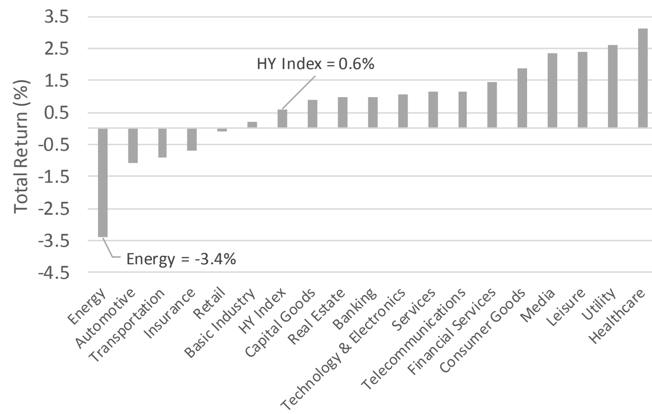
SKYView: Energy

Increased crude oil price volatility, political uncertainty, growing ESG awareness, falling Energy sector enterprise value multiples, and a mounting sense of strategic uncertainty have served to stifle investor enthusiasm for high yield Energy credits, with sector underperformance evident over the last three- and six-month periods.

ICE BofAML US High Yield Sector Returns
trailing **3 month** returns as of 17 Jan 2019



ICE BofAML US High Yield Sector Returns
trailing **6 month** returns as of 17 Jan 2019



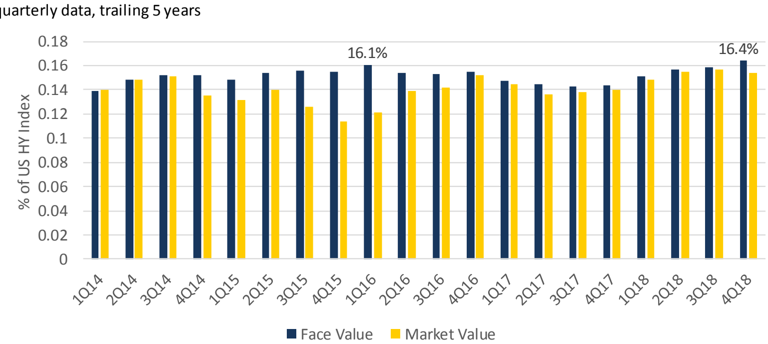
Source: SKY Harbor, ICE BofAML Indices

This performance drag along with an emergent lack of conviction regarding underlying commodity price directionality in the near to intermediate term has biased many generalist investors toward an underweight position in Energy, abandoning certain parts of the sector to the purview of specialists. Going forward, a paradigm shift toward greater consistency and predictability within issuer business models may be necessary to draw a more wide-ranging group of investors back into the sector.

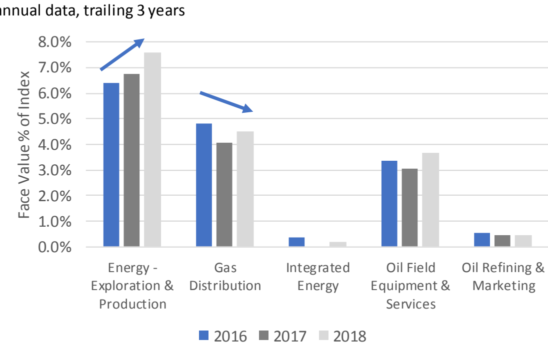
Sector Backdrop

A brief summary of the Energy sector in the current market cycle would include significant issuance in the years following the last recession, a crude price shock that began mid-2014 and troughed early-2016, and the subsequent wave of fallen angels and defaults from late 2015 through early 2017 (the latter of which peaked at nearly 27% on an issuer-weighted basis) that induced index-wide volatility. A modest commodity price recovery, operational cost cuts, asset sales / M&A, equity issuance, and the exit of the weakest credits via bankruptcy dramatically changed the sector landscape over the last several years. Although Energy's weighting within the US high yield universe (we use the ICE BofAML US High Yield Index, ticker H0A0, as a proxy) has fluctuated, the sector remains sizeable. Furthermore, sub-industry weightings have evolved, with the more volatile and commodity-dependent cohort – Exploration & Production – growing at the expense of lower beta issuers in the Gas Distribution space.

Energy Sector Weight Within US High Yield Index
quarterly data, trailing 5 years

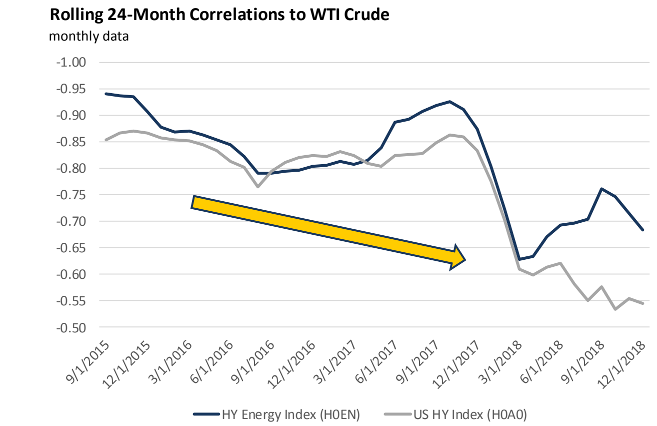


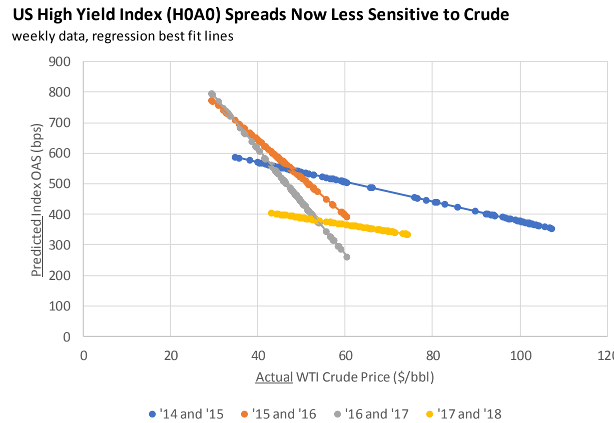
Energy Industry Weights Within US High Yield Index
annual data, trailing 3 years



Source: SKY Harbor, ICE BofAML Indices

Although seemingly counterintuitive, HY Energy Index spreads have historically shown very little correlation to underlying crude prices, a dynamic that changed dramatically in 2015 (correlations approached -1.00 as WTI dropped precipitously). At that time US HY Index spreads also became highly negatively correlated to oil prices, with the Energy sector driving risk premiums for the market as a whole. Those relationships have since moderated, as demonstrated below (left chart). Interestingly, changes in underlying WTI crude prices have only minimally impacted US HY Index spreads over the last several quarters, as demonstrated by the relatively flat regression best-fit line denoted in gold (right chart) in comparison to the relatively steep fit lines in prior year groupings. As a result, crude prices (and, ultimately, the health of Energy issuers) have diminished in importance with respect to high yield market performance following a spike from 2014 through 2016.

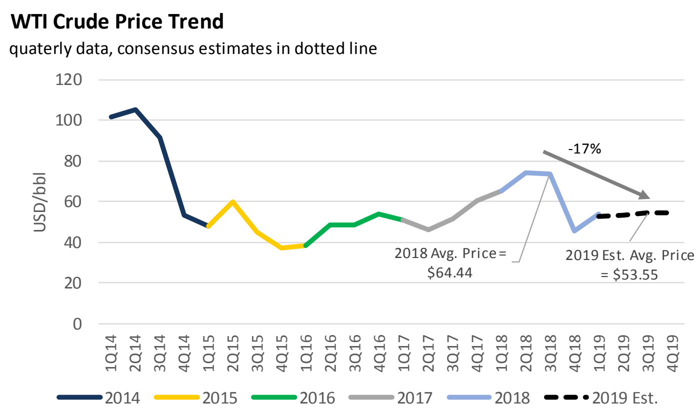


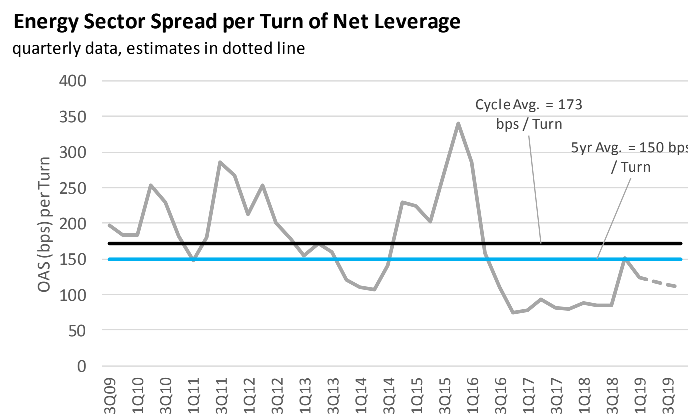


Source: SKY Harbor, ICE BofAML Indices, Bloomberg

Relative Value

Using street consensus expectations as a baseline, the outlook for crude oil pricing in 2019 is somewhat subdued. In particular, spot prices for WTI are ~ $52.21/bbl at the time of publication and are expected to rise only modestly to ~ $54.27/bbl by year-end 2019. Comparing consensus quarterly estimates to actual prices in 2018, WTI is expected to be ~ 17% lower on a y/y basis over the next 12 months. Assuming this decline translates into an equivalent amount of pressure on profitability in 2019, and assuming debt balances of index constituents do not grow (though they have for over 30 quarters in a row), Energy sector net leverage would increase to approximately 5.3x by 4Q19 (from approximately 4.4x at present). On a spread per turn of net leverage basis – which we believe to be the most useful gauge of relative value – Energy valuations appear rich (spread per turn will be below the cycle and trailing-5-year averages, and compares unfavorably to index-wide averages).





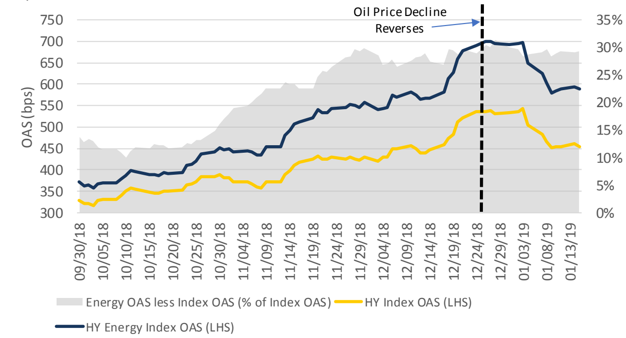
Source: SKY Harbor, BofA Merrill Lynch, Bloomberg

Furthermore, loan-to-value metrics (which we define as sector net leverage as a percentage of sector enterprise value multiples) are under pressure. We expect Energy sector net leverage to rise over the next four quarters, and equity market multiples have compressed rapidly over the last several months. **As such, we view the Energy sector (as a whole) to be below-average in terms of relative attractiveness**.

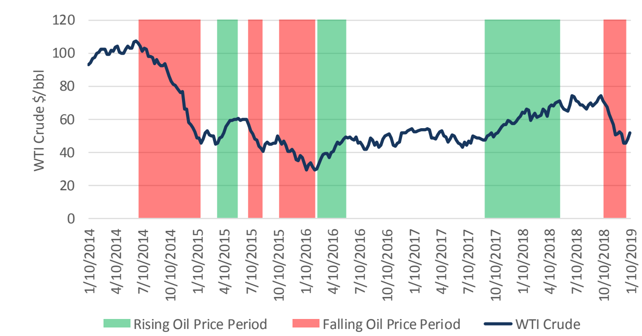
Skewed Upside / Downside Capture

A sustained rally in underlying crude prices (provided WTI and high yield spread correlations revert to '14 through '16 levels) undoubtedly poses the largest risk to investors with an underweight position in the Energy sector. In fact, WTI prices have moved up sharply over the last couple of weeks, recording a nearly 23% gain since December 24, 2018. With that said, investors have seemingly been reluctant to re-enter the space, as evidenced by essentially unchanged spread differentials between the high yield index and the Energy sub-sector since the crude rally began. As demonstrated in the chart below (left side), spread differentials between the Energy index and the full HY index expanded from the start of 4Q18 through the most recent WTI pricing trough (December 24), increasing from ~ 10% of full index spreads to nearly 30% of index spreads when crude bottomed out at $42.53/bbl. The differential has failed to compress during the subsequent crude rally, with the relationship unchanged even after WTI broke through $52/bbl. And, this phenomenon is not strictly a near-term anomaly. Looking back at the trajectory of crude prices since the start of 2014, we have identified three periods of sustained crude price increases, and four periods of sustained crude price decreases. On average, High Yield Energy Index downside return capture (periods below denoted in red) was 1.5x greater than upside return capture (periods below denoted in green). This unfavorable upside/downside capture rate, in our view, reduces the perceived risk of an oil rally for investors underweight the sector.

US High Yield Spreads vs. WTI Crude (4Q18 Selloff & January '19 Rally)
daily data



WTI Crude Price and Associated Investment Returns
weekly data, trailing 5 years



Source: SKY Harbor, Bloomberg, ICE BofAML Indices

Potential Headwinds

Purposely Slowing Growth Rates - Some equity analysts are calling on Energy management teams (particularly in the E&P space) to slow their growth rates, take a more moderate view on production and capex, and appease stockholders with increased dividend payouts. While a more prudent approach to capital allocation and the monetization of non-core assets may be well received by bondholders, the prospect of increasingly shareholder friendly initiatives could be worrisome should the damage of the latter outweigh the benefits of the former.
OPEC Cooperation / Aramco IPO – With the much anticipated Saudi Aramco IPO delayed (again) until 2021, there are fears that Saudi Arabia (and OPEC, in general) may be less incentivized to stabilize and/or boost oil prices in the near to intermediate term.
Equity Market Multiples – A rapid decline in EV multiples have materially depressed equity values for many high yield Energy companies. Relying heavily on equity markets to raise cash for the purpose of repaying debt and plugging free cash flow gaps in years past, issuers likely will not have access to that lever should the need arise going forward.
Commodity Price Disparity – A cursory look at Bloomberg shows an increasingly wide disparity between consensus estimates for oil prices and the strip. We believe this is further evidence of underlying oil price volatility, uncertainty and lack of conviction in the space, all of which will likely contribute to waning investor appetite.
ESG Considerations – An increasing awareness of ESG related factors (and, subsequently, a substantial amount of capital flowing into such strategies) may further limit the size and scope of the Energy investor base. Furthermore, pollution concerns, water usage, and overall increased regulatory scrutiny will likely increase operating costs for issuers going forward, diminishing profitability.

Inadequate Past Returns

Energy remains the largest sector in the high yield space (16.4% and 15.4% of the index by face and market value, respectively), giving rise to justifiable concerns over tracking error should manager sentiment lead to significant over/underweight positioning. With this in mind, we examined Energy sector returns relative to full indices (the ICE BofAML US High Yield Index as a proxy for broad market high yield, and the ICE BofAML 1-5 Year BB-B US Cash Pay High Yield Constrained Index as a proxy for short duration high yield) over the last decade. As shown below, avoiding the sector in its entirety would have been beneficial to returns in seven of the last 10 years (the HY Index ex Energy outperformed the HY Energy Index and the full HY Index). Additionally, excluding Energy would have been beneficial in rolling 3-month, 6-month, 1-year, 5-year, 7-year and 10-year periods ended 12/31/18, a dynamic unlikely to compel investors back into the space.

Energy Has Dampened US High Yield Index Returns in 7 of the Last 10 Years
annual data, best result highlighted grey

ICE BofAML US High Yield Index (proxy for broad HY)

		Periodic HY Index Total Returns		
	Year	Ex Energy	Energy	Full Index
Annual Periods	2009	58.36	51.14	57.51
	2010	15.47	12.95	15.19
	2011	3.84	8.51	4.38
	2012	16.18	11.65	15.58
	2013	7.64	6.14	7.42
	2014	4.32	(7.44)	2.50
	2015	(1.50)	(23.58)	(4.64)
	2016	14.18	38.44	17.49
	2017	7.46	7.62	7.48
	2018	(1.46)	(6.37)	(2.27)
Trailing Periods	3mo	(3.68)	(9.77)	(4.67)
	6mo	(1.31)	(7.66)	(2.34)
	1yr	(1.46)	(6.37)	(2.27)
	3yr	6.53	11.73	7.27
	5yr	4.43	(0.26)	3.82
	7yr	6.49	2.26	5.94
	10yr	11.42	8.04	10.99

ICE BofAML 1-5yr BB-B US High Yield Constrained Index (proxy for short duration HY)

		Periodic HY Index Total Returns		
	Year	Ex Energy	Energy	Full Index
Annual Periods	2009	42.91	41.86	42.78
	2010	12.79	11.92	12.71
	2011	4.02	6.51	4.29
	2012	12.75	10.03	12.45
	2013	7.59	5.98	7.44
	2014	2.70	(6.79)	1.75
	2015	(0.19)	(22.16)	(3.00)
	2016	11.02	19.18	12.23
	2017	5.02	7.45	5.38
	2018	1.19	(2.16)	0.67
Trailing Periods	3mo	(2.12)	(5.37)	(2.63)
	6mo	(0.07)	(3.52)	(0.61)
	1yr	1.19	(2.16)	0.67
	3yr	5.67	7.81	5.99
	5yr	3.88	(1.88)	3.28
	7yr	5.63	0.84	5.13
	10yr	9.42	6.01	9.07

Source: SKY Harbor, ICE BofAML Indices

Conclusion

Increased crude oil price volatility, political uncertainty, growing ESG awareness, falling Energy sector enterprise value multiples, and a mounting sense of strategic uncertainty have served to stifle investor enthusiasm for high yield Energy credits, with sector underperformance evident over the last three- and six-month periods. This performance drag, along with an emergent lack of conviction regarding underlying commodity price directionality in the near to intermediate term has biased many generalist investors toward an underweight position in Energy, abandoning certain parts of the sector to the purview of specialists. Going forward, a paradigm shift toward greater consistency and predictability within issuer business models may be necessary to draw a more wide-ranging group of investors back into the sector.

On the Calendar

Due to the US government shutdown, data releases have been postponed

Source: SKY Harbor, Bloomberg

Recommended Reading

Gold, Riva (2019, January 18). US Stocks Continue to Move Higher. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/global-stocks-extend-rise-as-u-s-mulls-tariff-drawdown-11547801567?mod=hp_lead_pos1

Bloomberg News (2019, January 18). China Offers a Path to Eliminate US Trade Imbalance, Sources Say. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2019-01-18/china-is-said-to-offer-path-to-eliminate-u-s-trade-imbalance