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Hermes Credit

Spectrum

Extracting returns amid lower-for-longer energy prices

Key points

The slump in oil prices shows no sign of abating, as OPEC continues to maintain production levels

Energy companies have been forced to adapt – some radically – particularly those in regions where the marginal cost of production is much higher

Some sectors of the industry will find it difficult to recover until capital expenditure resumes

However, companies benefitting from contracted prices and strong cash flows present attractive investment opportunities

The spotlight has shone on the energy industry since late 2014, when OPEC began focusing on protecting its market share. Spot oil prices have since plunged 67%, forcing rival US shale oil producers to halt much of the output that had challenged the establishment's dominance.

Previously, greater use of extraction techniques to access shale oil and gas reserves was rapidly changing the energy industry by creating opportunities for businesses throughout the production cycle. However, many of these entrants have been forced to focus on survival rather than growth as oil prices have remained near production costs.

This has led to a broad deterioration in the cash flows of energy companies, and therefore credit metrics, resulting in debt defaults and downgrades by rating agencies. Although this has substantially altered the investment opportunities available within the market, we continue to find attractive credit instruments to invest in. We believe that there is a "sweet spot" in the energy sector featuring issuers with credit metrics that would support ratings in the BBB to BB range. These companies have experienced less volatility and weakness than the industry as a whole. However, with energy prices likely to stay lower for longer as OPEC maintains its existing level of output, we have continually assessed the industry to identify which sub-sectors and businesses have been fundamentally damaged and those that are likely to survive.

Red flags in a low-price environment

Since energy prices collapsed, restricting growth opportunities in the sector, we have focused on companies that can survive on their own cash flows. This ability is crucial, as management teams have reasonable control over cash outflows but little influence on credit availability – and almost no say on external factors, such as oil prices.

The companies most attractive to us have marginal (or better) free cash flow, do not require access to the capital markets and should not need to sell assets when prices bottom out, as we believe that they could be suppressed for at least two or three more years. Such companies operate within their means, preserving cash and liquidity as they adapt to a sustained period of low prices in a number of ways, including: reducing labour costs and operating expenses, streamlining capital expenditure by cancelling and deferring projects, and suspending dividends and share buybacks. While these actions are painful, they signal a strong corporate culture which is more likely to preserve cash flow in the long term. Failure to make such decisions would cause us to question whether the company can deal with the hostile operating environment.

The companies most able to weather the downturn also have strong capital structures and manageable credit requirements. While they are unlikely to access capital markets or new credit facilities in the current conditions, we expect that banks would be willing to extend debt agreements with additional covenants and collateral. However, we are wary of any instruments that require loan extensions beyond material bond maturities, as this suggests that the entire capital structure of the company would need to be re-assessed. We would also be wary of companies that have amended bank agreements to include junior liens, which can allow incremental liquidity but have superiority over unsecured bonds in the event of restructuring.

Another concern for us in the current market is the lack of clarity regarding borrowing base determinations. These are a unique feature of loans to lower-rated energy companies that allow banks to revalue the assets on which a loan is based, effectively reducing the available credit in the current conditions. US banks, particularly regional banks, are under close regulatory scrutiny to minimise losses in the industry and are aggressively enforcing redeterminations. Almost all high-yield energy companies are exposed to the risk of redetermination, which fundamentally affects their investment cases.

> The global increase in production up until November 2014, which was based on buoyant price expectations, shows how quickly market conditions can change and assumptions rendered useless.

Rigging up: assumptions about energy going forward

Keeping these fundamentals in mind, we assess energy industry companies on their ability and willingness to pay creditors on time. For this purpose, we test for the "five Cs" of credit:

- Capacity
- Capital
- Collateral
- Conditions
- Character

We also consider broader factors, such as the state of the economy, structure of the industry, strength of the competition, the ability of consumers to switch from one energy source to another, and the political and legal frameworks that apply.

Among energy companies, we favour those that demonstrate an ability to generate cash flow from their existing assets, capabilities and capital structure. But this can be complicated as the sector is global, highly competitive, cyclical, politicised and heavily regulated, presenting a range of variables that influence a company's operations. To ensure that we take into account as many of the potential outcomes for the industry as possible, in our analysis we use normalised and stressed commodity price levels, alongside determining break-even levels, for both the costs of production and the market value of output. Energy is a highly cyclical sector, with periods of volatile pricing of varying length, and industrial suppliers and consumers operate on the basis of medium- to long term-pricing projections. The global increase in production until November 2014, which was based on buoyant price expectations, shows how quickly market conditions can change and assumptions rendered useless. Encouragingly, the industry responded quickly. New drilling programmes were rapidly suspended, relieving pressure on producers. However, this makes it less clear when the supply-and-demand balance, and therefore prices, will recover.

We are prepared for prices to remain range-bound around the level of marginal full-cycle costs, roughly similar to the current price of $40-$50 per barrel, for some time. Cash costs can range between $3-$30 per barrel, and non-cash costs, which are an estimate of the cost of replacing reserves that were depleted for current production, can vary between $10-$30 per barrel.

Tapping into energy

While there is some overlap, we broadly categorise the energy sector into five segments: integrated companies, exploration and production, refining and marketing, pipelines and oil field services. Each category has distinct characteristics which result in different credit implications and, therefore, different investment cases.

1. Integrated companies

Characteristics

- Complex, mega-cap resources companies
- Involved in the full energy cycle, from exploration to distribution
- Can buy or sell a range of assets – properties, drilling rights, refined products or natural gas – at intermediate points
- High capital expenditure in long-life projects
- Significant, long-term capital requirements
- Able to mitigate pricing risk as marketing refined product is a natural hedge against exploration and production costs
- High operational risk, low financial risk
- Include national energy companies and publicly owned multinationals
- Mostly investment-grade businesses, with some high-yield issuers

Key risks

- The size and long time horizons of projects leads to extended execution risks
- Reserve replacement is slow: given the large operations of these companies, new discoveries must be substantial in order to sustain overall production
- Operational failures have significant environmental, social and governance impacts

Investment view

For a company in this category to become an investment opportunity for us, it must be liquid and financially flexible, with access to capital markets and have the ability to sell assets and suspend dividends to meet unexpected capital demands.

2. Exploration and production

Characteristics

- "Upstream" companies that find, develop and produce oil and gas
- Sensitive to commodity prices as these products are sold to intermediaries
- Have expertise in geography, types of production, extraction techniques and specific technologies
- Projects carry higher risk as their size relative to the available credit is greater

Key risks

- Locations of reserves
- Local regulatory and operating regimes
- Funding of cash flow requirements
- Hedging of future production
- Environmental remediation capability

Investment view

We assess the ability of management to deal with operational and financial stress through their assets, capital structure, and financial and operating strategies.

As a result, we aim to select well-run, low-cost exploration and production companies with manageable leverage and diversified assets that exhibit good recovery value. Conversely, we minimise exposure to companies with limited diversification, high geopolitical risks, elevated operational risk (such as small offshore drillers or those in environmentally sensitive areas) and highly leveraged or distressed companies. Many high-yield issuers in the sector operate in this space, including unconventional fracking and horizontal drilling shale companies, providing some attractive opportunities.

3. Refining and marketing companies

Characteristics

- "Downstream" companies that convert crude oil into end products, which include jet fuel, gasoline and asphalt
- Market products directly and through intermediaries (often independent distributors)
- Distribution tends to be localised
- High-risk operations

Key risks

- Complex logistics
- Seasonality
- Product mix
- Scheduled plant shutdowns for maintenance and refurbishment
- Unscheduled outages
- Environmental and regulatory requirements
- Exposure to two different volatile pricing markets
- Negative working capital

Investment view

After considering these risks, we look for refiners that are diversified across multiple locations and have the financial strength to withstand the pressures of volatility, cyclicality, and operational and environmental mishaps. Since refiners convert raw crude oil into products, they are the only segment exposed to price volatility at both ends of their process, and they do not tend to hedge against the costs of either input crude oil or the prices of refined products.

4. Pipelines

Characteristics

- "Midstream" companies that provide logistics to support the gathering and distribution of crude oil and its end products
- Owners and operators of the required assets (including pipelines, storage and processing assets)
- Dependent upon long-term or favourable regulation
- Sensitive to location-specific supply and demand balances
- Minimal exposure to price and volume volatility due to long-term contracts and fee-based business models
- Long-life assets that are matched by long-term financing
- Cannot respond quickly to changes in demand
- Significant capital requirement

Key risks

- Contract integrity
- Supply and demand interruptions
- Leakages
- Accidental damage of assets
- Physical deterioration of assets

Companies can reduce their exposure to these risks when they match financing with contractual terms, minimise price and volume exposure and maximise long-term usage. The segment's stable, enduring cash flows are particularly attractive to credit investors.

Investment view

In our view, this is a defensive subsector with low volatility. We like midstream issuers with multiple sources of fee-based revenue that provide stable cash flows with predictable margins. Pipeline companies have a place in portfolios with a requirement for long-dated bonds. We expect the merger and acquisition activity that has been prevalent in this subsector to continue, expanding the range of opportunities on offer. We also expect a rise in demand for new gathering and distribution systems. To satisfy this, companies will require large amounts of investment capital.

5. Oil field services

Characteristics

- Supply equipment and services to businesses throughout the production chain
- Primarily supply integrated and exploration and production companies
- There are three dominant multi-service providers
- Most have technical or geographical specialisations

Key risks

- Operations are leveraged to the capital expenditure of clients
- Prices and margins have fallen as drilling has declined
- "Blend and extend" terms mean lower prices are locked in

Investment view

We have avoided the smaller, specialised oil field services companies primarily because these are less likely to have stable, predictable cash flows. The bonds of larger, multi-service providers offered low value for the risk prior to the OPEC decision and this remains unchanged, even with higher spreads. As a result, we have scant exposure to this segment. However, we expect it to rebound once producers resume capital expenditure, which depends on a sustained increase in the oil price.

Playing lower energy prices for longer

The impact of lower prices for the long-term will vary significantly among businesses across the sector. We expect prices to remain aligned with production costs for some time to come. In this environment, we will continue to seek credit instruments in the lower investment grade or upper high yield quality ranges and favour companies with strong free cash flow. These companies must also be able to preserve these characteristics amid low prices. As a result, we expect to have very limited exposure to oil field services companies, as they could potentially suffer most from the cyclical downturn. Conversely, we see attractive opportunities in the pipeline subsector and selective opportunities in the exploration and production subsector, particularly among drillers with diversified assets, low leverage and competitive technology, and pipeline operators whose consistent margins and fee-based revenues help to generate stable cash flows.

Hermes Investment Management

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Hermes Investment Management

Hermes Investment Management is focused on delivering superior, sustainable, risk-adjusted returns – responsibly.

Hermes aims to deliver long-term outperformance through active management. Our investment professionals manage equity, fixed income, real estate and alternative portfolios on behalf of a global clientele of institutions and wholesale investors. We are also one of the market leaders in responsible investment advisory services.

Our investment solutions include:

Private markets

International Real Estate, Pooled funds, Segregated mandates, UK Real Estate, UK Real Estate Debt, Infrastructure, Private Equity.

High active share equities

Asia, Global Emerging Markets, Greater China, Europe, Global and Small & Mid Cap.

Specialist fixed income

Global High Yield Bonds, Multi Strategy Credit, UK Government Bonds and UK & Global Inflation-Linked Bonds.

Multi asset

Multi Asset Inflation.

Responsible Investment Services

Corporate Engagement, Intelligent Voting, Public Policy Engagement and PRI.

Offices

London | Singapore

Why Hermes Credit?

Edge

A focus on security selection through the capital structures, and across debt instruments, of issuers worldwide. We believe that capturing superior relative value depends as much on finding attractive securities as identifying creditworthy companies. This approach helps to deliver strong returns through the cycle.

Rigorous, repeatable process

Intensive relative-value investing in bonds, loans and derivatives. This bottom-up credit selection is guided by top-down analysis. Risk management is a core function at all stages of our investment process.

Experienced team

Skilled, integrated team whose principal members have worked together since 2004. We are expert managers of global multi-strategy, high-yield and investment-grade credit strategies.

Aligned interests

The autonomy of a boutique with the operational strength of an institutional fund manager. To ensure our interests are aligned with our clients', long-term outperformance is a condition of incentive pay. The Hermes Investment Office performs independent risk management.

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