PORTFOLIO INSIGHTS

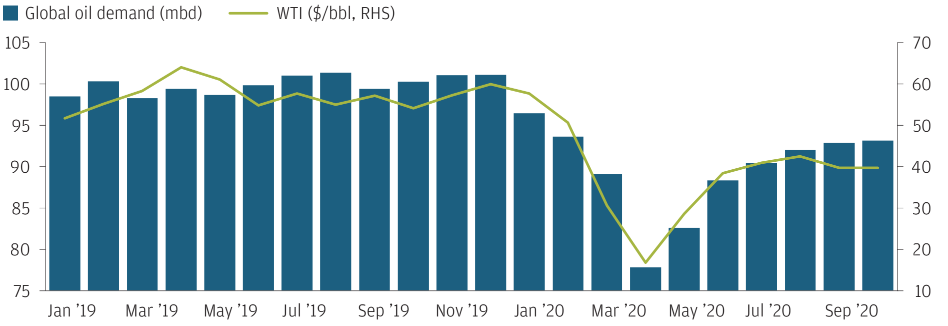
Sector review: Energy

November 2020

The global shutdown led to a significant decline in energy demand. Continued uncertainty poses questions over the sustainability of the capital structure for some high yield energy companies.

The high yield energy sector started 2020 with some optimism, with oil prices around $60 per barrel (West Texas Intermediate – WTI) allowing some energy credits to tap the high yield market during the first weeks of January. However, this optimism quickly faded amid mounting concerns around growing oversupply, which culminated in the first weekend in March with the Saudi-Russia price war. Global stay-at-home and/or safe distancing requirements to tackle the Covid-19 outbreak followed close behind, leading to a significant decline in demand for energy – in particular, refined crude oil products such as petrol, jet fuel and diesel. The size and speed of the drop in global demand caused oil prices to decline by more than 50% from the beginning of March to the middle of April – bottoming below $20 for both Brent crude and WTI.

EXHIBIT 1: COVID-19 IMPACT ON GLOBAL OIL DEMAND



Source: JP Morgan Commodities Research as of 31 October 2020. mbd - million barrels per day. bbl - barrel unit.

In response to the significant drop in oil prices, exploration and production (E&P) companies quickly and aggressively reduced their capital programmes and curtailed production at wells that were not cash flow positive in an effort to minimise the drain on their cash. The reduction in drilling and completion activities across the industry had a negative follow-on effect on oil field service companies, with the decline in demand for their equipment and services having a cataclysmic impact (the Baker Hughes US rig count for oil focused drilling troughed at 172 as of 14 August and has rebounded to 221 as of 30 October, but still materially lower compared to 678 at the end of February). Meanwhile, midstream companies are facing flat-to-declining throughput volumes across their assets due to the decline in drilling and lower economic activity.

The net result was that, on average, energy companies faced significantly lower earnings and cash flow, higher leverage and tightening liquidity in the second quarter. Within high yield energy, 24 companies ($36 billion of par value) have defaulted between the beginning of March through the end of October. Of these 24 companies, 14 were E&P companies, nine were oil field services companies and one was a midstream company.

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Looking forward

Following the stabilisation of oil prices in the low $40 range in July and August, the reacceleration in Covid-19 cases across much of the globe is negatively impacting the recovery in oil demand, while at the same time Libya has increased oil production. These events highlight the level of uncertainty around the timing of any return to a balance in the demand and supply of oil. As a result oil prices have once again experienced volatility to the downside, recently trading in the mid-to-high $30s, levels not seen since mid-June of this year.

The majority of the legacy high yield energy E&P companies will continue to face challenges in a sub-$50 oil price environment. Also, although the recent fallen angels generally have lower all-in breakeven costs, their credit improvement will be slow. We expect the energy space to continue to experience an elevated default rate relative to the high yield market as a whole.

Investment opportunities

Given the uncertain economic and demand-side environment, the fundamental outlook for the energy sector is challenging. The tough backdrop raises question marks over the sustainability of the capital structure of a number of companies.

Recently the E&P industry has experienced a handful of corporate M&A transactions. The primary characteristics of these transactions have been for the combined company to gain absolute and in-basin scale; to realise both overhead cost and operational synergies to lower corporate breakevens and increase cash flow; while maintaining a strong balance sheet. Within high yield E&P, three companies have been part of these transactions and the expectation is for the bonds of each of them to be upgraded to investment grade after their respective mergers close. While we believe the sector could see further consolidation, we see a very limited number of potential high yield E&P targets that have the quality of assets, absolute scale and balance sheet strength that would lead to a transaction with an investment grade company.

While the energy sector trades roughly 300 basis points wide of the overall high yield market, there is a significant dispersion in spreads across the energy universe. Within the sector, we prefer the relative stability of midstream companies compared to E&P and to the oil field services companies, where valuations relative to risks appear unattractive - although we do see select opportunities for investment.

NEXT STEPS

For more information, contact your J.P. Morgan representative.

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