FRONTIER
ADVISORS

# The Frontier Line

Thought Leadership and insights from Frontier Advisors

## Opportunistic investing in US energy

Issue 109, November 2015

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $250B in assets across the superannuation, charity, public sector and higher education sectors. The fact our advice is fully independent of product, manager or broker conflicts, means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

*The Frontier Line* explores a range of investment issues and ideas to explain and illuminate areas for investors to be aware of and be thinking about. Our specialist and sector research teams constantly review and discover topics to provide new perspectives and enrich understanding of critical risks and opportunities.

**Kim Bowater** is a Senior Consultant at Frontier, having joined the firm in 2002. Her responsibilities include advising clients on investment policy and overseeing Frontier's investment research program.

Kim was previously employed at Deloitte Touche Tohmatsu, providing investment administration and strategic custody advice to institutional clients including superannuation funds, investment managers, broker/dealers and custodian banks worldwide. Kim also worked for Towers Perrin in both global custody and actuarial/employee benefits consulting. Kim is a Chartered Financial Analyst, member of the CFA Institute and holds a Bachelor of Science degree with First Class Honours in Mathematical Statistics from Monash University in Melbourne.

**Frontier Advisors**

Level 16, 222 Exhibition Street
Melbourne, Victoria 3000
Tel +61 3 8648 4300

**www.frontieradvisors.com.au**

**@frontier_adv**

# Opportunistic investing in US energy

**The fall in the oil price over the past year or so is one of the largest asset price moves in recent times. For nimble investors, this presents new investment opportunities to achieve potentially outsized risk-adjusted returns – this Frontier Line explores this opportunity in more detail.**

## Overview

Frontier has been assessing the implications for portfolios from the fall in the oil price since it first declined in late 2014.

From an asset allocation perspective much work has been done determining the type of oil price shock (i.e. demand or supply driven), the impact on the real economy, analysis around previous oil shock periods (e.g. 1986, 1997) and the likely medium term impact on equity markets.

We consider the fall in the oil price to be primarily supply driven. The growth in global oil supply has been driven by non-traditional supply in the US. Technology advancements in hydraulic fracturing (fracking) and horizontal drilling have enabled US producers to extract oil from shale formations increasingly efficiently, with the US now the largest oil producer globally.

OPEC's decision in 2014/15 to maintain supply levels (despite price falls) and defend market share, has also put downward pressure on the oil price. Despite an increase in US demand for oil, overall demand growth has eased driven mainly driven by the slowdown in China and supply is expected to continue to outstrip demand into 2016.

Frontier has also assessed investment opportunities resulting from the oil price fall. In late 2014/early 2015 we considered the merits of accessing this opportunity in a liquid and low cost way via long only high yield (energy sector) and emerging market debt (oil producing sovereign debt) exposure. We concluded at the time that these were not attractive risk adjusted return opportunities. Indeed, a high yield or emerging market debt "beta" play has proven a risky strategy to date. More recently we have focused on the case for opportunistic investing in US energy, taking advantage of pricing dislocation caused by the fall in oil price.

"Opportunistic investing" means an active strategy, typically implemented by an alternative manager in both tradeable and private companies/assets. This type of manager makes use of proprietary deal flow, is experienced in structuring complex and multifaceted transactions, and has a focus and skill set in stressed/distressed situations.

Frontier has spoken to a range of alternative managers with an opportunistic and/or energy specialist capability. The investments we have focused on are generally higher returning risk opportunities and offered by managers in the opportunistic/alternative space. As a result, the strategies are generally higher fee and less liquid.

# Opportunistic investing in US energy

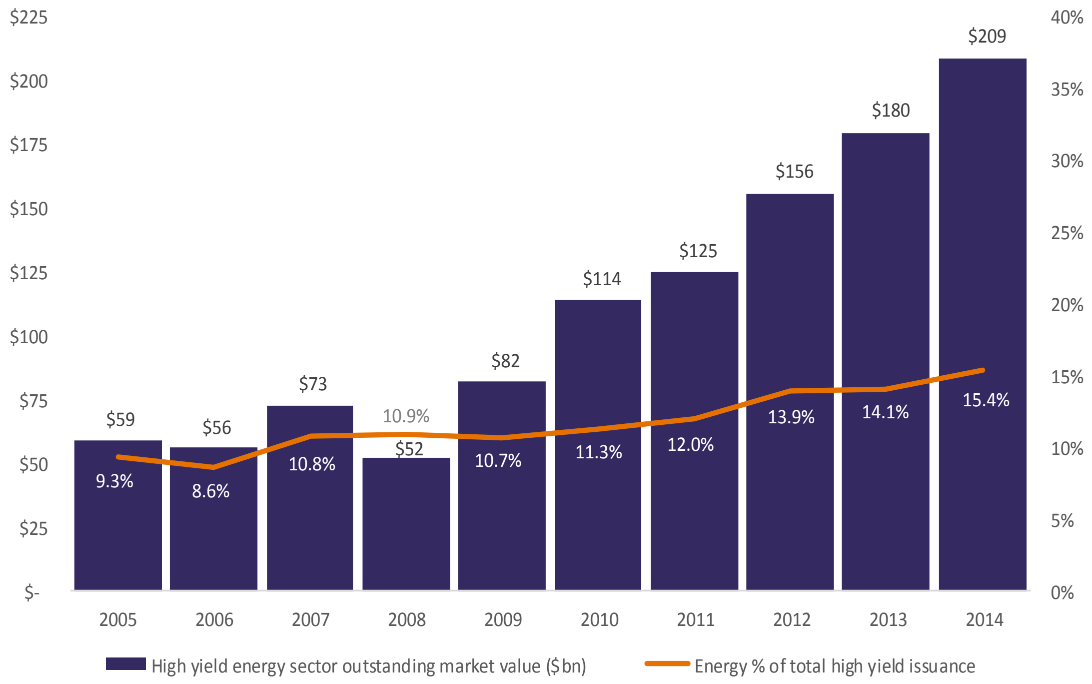
## Focus

US E&P (Exploration and Production/ upstream) oil companies, particularly shale, are our key are of focus for this opportunity, as this industry is at the centre of the current stress caused by the fall in oil price. The opportunity set is of course broader than this, including other parts of the energy sector and related industries (e.g. oil and gas service companies).

## Catalysts for stress/distress

In recent years, capital market participation in US energy industry growth has been significant, with high yield debt markets in particular a key source of capital for E&P shale oil producers. This has led to some balance sheet excess, making parts of the sector more susceptible to stress from a fall in oil price. While investment grade credit and equity markets have been somewhat impacted at the sector level, these higher quality companies have experienced less balance sheet issues on average. The bank loan market has limited E&P exposure.

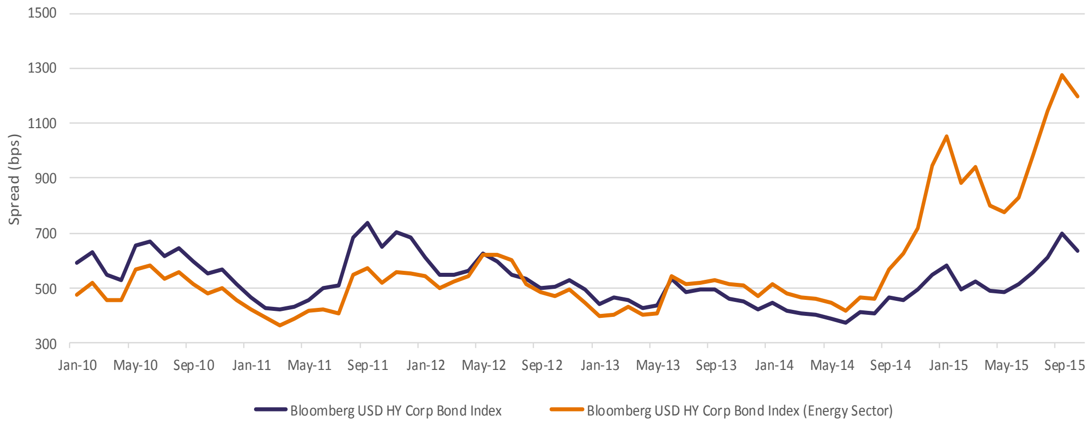
**Chart 1: Energy contribution to US high yield market (US $bn)**




Source: GSO, Deutsche Bank Fixed Income Research as of March 2015
E&P represents almost 60% of the energy sector, the remainder being midstream, services and refining companies

# Opportunistic investing in US energy

**Chart 2: Energy high yield historical spreads**




Source: Bloomberg, Frontier, data to end October 2015

The openness of the high yield market to E&P issuers has varied since the initial oil price fall, with debt markets reopening from February 2015 to June 2015 following the market's more positive view around the speed of the oil price recovery. This period of capital raising, coupled with the opportunity for companies to hedge production in a higher oil price environment served to delay greater stress in the energy sector.

Following more recent falls, the high yield market has been more cautious and is effectively closed to E&P issuers. This has created greater stress/distress as much of the debt issued earlier in 2015 is uneconomic at current oil prices with the market punishing more speculative companies and companies with higher leverage and lower quality assets. Defaults in this sector have begun to rise, and the proportion of energy companies in high yield markets now considered to be "stressed" has increased meaningfully. Managers that invested in the first part of 2015 expecting an oil price rally have been hurt, while more cautious managers targeting private opportunities with idiosyncratic characteristics have fared better.

In addition to the oil price remaining low or falling further combined with overlevered balance sheets, other catalysts for distress in the E&P sector include rolling off of oil price hedging and potential tightening of financing conditions due to regulatory pressure. While many companies have remained well hedged, oil price hedging is expected to roll off in force over 2016, leading to a significant change in revenue. Reserve based lending (RBLs) is under increased regulatory scrutiny. Small and midcap E&P companies rely on RBL debt facilities for financing their operations. To determine borrowing capacity, the proved reserve value is recalculated for each producer by bank-approved outside engineers twice a year (the redetermination process). As shale wells deplete over time (unlike oil wells), companies require capital to turn undeveloped reserves into proved developed producing reserves in order to restore the borrowing base and maintain cash flow.

The most recent RBL redeterminations in October this year were broadly benign, with banks tending to maintain liquidity levels and choosing instead to increase capital reserves against potential loan defaults.

However, should the price of oil and broader commodities remain low into 2016 we believe the RBL process in April next year should provide a catalyst for stressed/ distressed investors.

## Investment opportunity

We see the investment opportunity as being primarily in energy companies that have historically sought funding through the high yield market, as well as private companies and assets that can be accessed at attractive pricing due to financial stress. The opportunity can be accessed via a debt or equity oriented strategy.

Table 1 outlines the range of strategies that may be taken by alternative managers in accessing the energy opportunity.

It is likely that there will be attractive opportunities across the risk spectrum – from senior debt financing to private equity investments. The success of individual strategies will also vary based on the path and trajectory of the oil price. For example, the distressed for control cycle is likely to be some time away and some companies may engage in value destructive activities prior to default, reducing the attractiveness of this strategy. We prefer strategies that have an attractive expected return for the risk taken, while limiting the downside risk from falling or "lower for longer" oil price scenarios.

### Table 1: Alternative manager strategies

| Strategy | Market liquidity | Target return profile [1] |
|---|---|---|
| New debt issuance including exchanges (layering) | tradeable, relatively more liquid | low to mid |
| Stressed high yield debt (performing) | tradeable, relatively more liquid | mid |
| DIP financing (yet to occur) | tradeable, less liquid | mid to high |
| Off balance sheet/private debt financing | private, less liquid | mid to high |
| Off balance sheet structured deals (e.g. debt/equity upside and/or asset based) financing | private, illiquid | mid to high (risk matched) |
| Distressed for control | typically tradeable to private (illiquid) | high |
| Platform investing (equity in management company, building platform via asset purchases) | private, illiquid | high |
| Private equity | private, illiquid | high |

1. Indicative returns: low: low double digit returns, mid: around 15%, high: 20%+

## Is this a single factor strategy?

An investment at this time in the US energy market risks being a single factor strategy – one whose success is intrinsically tied to the oil price recovery. While investments by their nature will be impacted by the oil price, strategies exist where success will be driven by idiosyncratic factors rather than a purely directional oil price relationship. In particular, investments that are expected to perform in a range of oil price scenarios have merit. Defensive features may include capital structure seniority, purchased to be economic at a very low oil price, high quality assets, and lowly geared companies. Structured investments in the mid to higher risk area that also include exposure to additional upside from an oil price recovery (via equity, warrants and/or underlying asset capacity) are also attractive as they should achieve strong returns if and when the oil price returns to a higher level.

## Key risks

In addition to the obvious uncertainty around the oil price level, there are a number of key risks that should be considered with this investment opportunity. Significant capital has been raised to invest in the stressed/ distressed US energy opportunity, with managers either targeting exposure within a broader mandate/fund or raising commitments for an energy-specific fund. This will likely limit the attractiveness of some more common strategies. Given the specialised nature of this sector and proprietary information required to assess and price risks, it is essential to invest with managers that have appropriate energy expertise. In addition, environmental risks are another facet of this opportunity that needs to be appropriate assessed and understood. These risks further demonstrate the need for active management and specialist skills.

**Overall, we believe that challenges to the US energy sector should create opportunities for stressed/distressed strategies to generate attractive risk adjusted returns over a medium-term horizon. This is attractive in a low return forward looking environment. We have identified a number of strategies that are likely to provide an attractive risk/ return proposition and reduce the single factor risk of the oil price.**