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‘High’er Yield in Energy Bonds

By Carson Tong, Associate Portfolio Manager, Signature Global Asset Management
June 20, 2019

With everything going on in macro land and energy land, I wanted to give you a quick update on what we’re seeing on the fixed-income/bonds aspect of some of the energy companies we own. Our high conviction across our positions stems from our strong understanding of the assets and acreage, access to information from our scale and resources, and strong relationships with management teams, which we have cultivated over many years.

Oil Prices – Bouncing Around the Lower Range

In the past few months, we have seen a pickup in geopolitical risks, specifically attacks on oil tankers in the Gulf of Oman near the Strait of Hormuz and recent sanctions against Iran and Venezuela. The former are not to be ignored as roughly 40% of the world’s seaborne oil travels through there.

As the West Texas Intermediate (WTI) crude oil price hit US$66.40 a barrel on April 23 and has since declined into the low-US$50s on the back of escalating trade war tensions and the prospects for decelerating global economic growth, we believe range-bound oil price levels are constructive for the high-yield energy markets, but only for companies with scale and Tier-1 acreage (i.e., highly economic wells at low oil prices). Assuming global oil demand remains robust, we believe oil prices are range-bound in the near term due to the perception of an OPEC+ “put” to keep prices from falling too low and high elasticity of supply of U.S. shale oil fields if prices run too high.

As for members of the Organization of the Petroleum Exporting Countries and other major oil-exporting nations (“OPEC+”), they have agreed to extend their supply-cut agreement through the second half of 2019. The next OPEC+ meeting is expected to take place in early-July 2019 in Vienna. With oil markets currently in balance, we will continue to closely monitor global economic growth and any impacts from trade tensions on these markets.

Defaults – Round Two and Avoiding Them

So far in 2019, in the energy sector we have seen a number of defaults/recapitalizations and high-yield bonds trading into deeply distressed levels, which have weighed on the performance of the

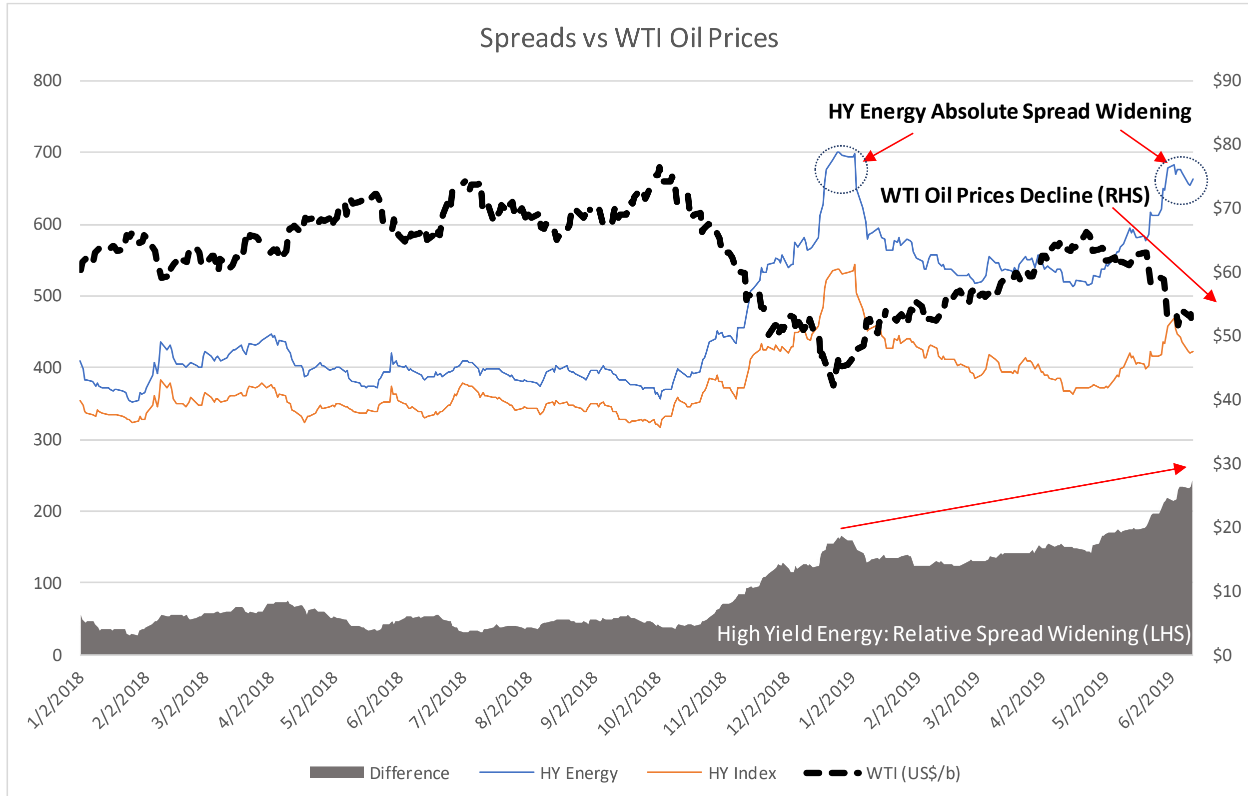
sector. Some notable energy exploration and production company defaults/recapitalization this year include **Jones Energy, Inc.**; **Vanguard Natural Resources, Inc.**; and **Bellatrix Exploration Ltd.**, all of which we have avoided due to our strong bottom-up research as part of our investment process. There have also been a number of energy producers whose bond prices have dropped over 40% this year and are trading at highly distressed levels, with a few expected to file for Chapter 11 (in the U.S.) or *Companies' Creditors Arrangement Act* (in Canada) bankruptcy protection for a second time. These companies likely suffered for not cleaning up their balance sheets since the last downturn in the energy sector in 2015–16, were poorly managed with new equity holders swinging for the fences, their acreage was challenged to begin with and/or suffer from pipeline-takeaway issues.

Valuations – Looking a Bit More Attractive

On the back of a number of de-leveraging events during 2017–18, the financial health of high-yield energy and production companies in the energy sector has improved over the past few years, and a few are now allocating capital toward share buybacks, dividends and selective mergers and acquisitions (M&A).

The ICE BofAML US High Yield Energy Index has lagged the broader ICE BofAML US High Yield Index this year and spread differentials have widened to levels that exceed those in late 2018 (see chart below). As such, we believe a spread of **+664** points for "High Yield Energy" and +**242** points over the broader "High Yield Benchmark" or a yield-to-worst of **8.66%** offers an attractive risk-adjusted return in select areas of the energy sector (see chart below).

High-yield Energy Bond Spreads vs WTI



Sources: ICE BofAML Bond Indices and Bloomberg L.P. Market data as at June 12, 2019.

M&A – A Flurry of Them in 2018, But Wait ... There's More

We believe the M&A market could provide an advantage for high-yield bond issuers that are motivated to sell. Last year, there were notable M&A transactions that took place, including those between **Concho Resources Inc.** and **RSP Permian, Inc.**; **Diamondback Energy, Inc.** and **Energen Corp.**; and **Encana Corp.** and **Newfield Exploration Co.**, with each representing US$8-10 billion in size. The most noteworthy transaction so far this year has been **Occidental Petroleum Corp.**'s acquisition of **Anadarko Petroleum Corp.** for more than US$50 billion. We believe scale matters to efficiently develop shale resources, and we expect more consolidation to take place over the next 12 to 18 months.

On the Canadian oilsands front, although we saw **Husky Energy Inc.** walk away from acquiring **MEG Energy Corp.** earlier this year, we would note **Canadian Natural Resources Ltd.**'s recent

purchase of **Devon Energy Corp.**'s Canadian operations, which includes Jackfish (a thermal oilsands project), is similar to that of MEG Energy's Christina Lake operation. We believe the valuation for these assets was attractive for Canadian Natural Resources and is a positive sign that there are buyers for high-quality assets similar to that of MEG Energy. However, in the near term, we believe pipeline issues in Western Canada will continue to plague the broader energy industry and its ability to grow.

Finally, **Pacific Oil & Gas Ltd.** announced the acquisition of **Canbriam Energy Inc.**, a natural gas producer in the liquids-rich Montney formation in Western Canada, but Pacific Oil & Gas had bonds due this year and was trading at distressed levels just prior to this announcement in May. For background, Pacific Oil & Gas owns the planned liquefied-natural-gas export terminal Woodfibre LNG, which is currently in pre-construction phase, and our understanding is Canbriam Energy will be the source of gas for this facility.

Portfolio Positioning – Low-cost Oil Basins and Selective Bonds Where We Can Generate Excess Returns with Limited Downside Risk

Our defensive positioning of Signature funds (by holding high-credit-quality bonds) benefited our funds during the sharp sell-off of bonds in the fourth quarter of 2018, and despite the gains made in the first quarter of this year, our funds were still able to generate positive returns by avoiding many defaults that have happened during the first half of 2019. (As at June 12, 2019, Signature High Yield Bond II Fund returned 6.1%, Signature High Income Fund returned 11.3% and Signature Corporate Bond Fund returned 6.1%.)

As we enter the second half of 2019, we have added a more offensive positioning in high-yield bonds in the energy sleeve (by incrementally adding fund exposure to bonds that benefit from rising oil prices) as part of a short-term trading strategy, but we remain defensive as we enter into the late stages of the business cycle. Core positions include energy producers in the low-cost parts of the Permian Basin oil fields in southwestern U.S. with M&A upside potential (e.g., **Endeavor Energy Resources, LP** and **Parsley Energy, Inc.**), private investments in the liquids-rich Montney shale fields (e.g., **Velvet Energy Ltd.** and **Saguaro Resources Ltd.**) and issuers that are motivated to pay down debt (e.g., MEG Energy).

Following are our weight in high-yield bonds of companies in the energy sector across the following Signature funds: Signature High Yield Bond II Fund, **17.0**%; Signature Corporate Bond Fund, **9.5**%; and Signature High Income Fund, **8.4**%. At current oil prices and with cost structures reset lower, all our energy investments are expected to generate strong cash flows, which is a

better indicator of credit quality than volume growth. Thus, our current positioning in higher-quality bonds is still greater than that in the benchmark ICE BofAML US High Yield Energy Index.

Sources: Signature Global Asset Management, ICE BofAML Bond Indices, Bloomberg L.P. and Company Reports, as at June 12, 2019.

Carson Tong (right) during a recent due-diligence trip to oil fields near Bakersfield, California.

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Published June 20, 2019.

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