Market Update Call – Audio Transcript

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Speakers:

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Opening: This is a recording of the U.S. Bank Wealth Management Market Update Call held on March 15, 2016. The discussion featured insights on the recent energy market decline and its impact on the capital markets.

Rob Haworth: Hello and welcome to our market update discussion hosted by U.S. Bank Wealth Management. I'm Rob Haworth, Senior Investment Strategist for the Wealth Management Group.

On today's call, we're going to have a candid conversation with our special guest speaker, Adam Flikerski from BlackGold Capital Management, based in Houston, Texas. We're very pleased that Adam has agreed to join us today to share his views on the potential impacts the recent energy market declines might have on capital markets and provide some perspectives on what opportunities he sees that may be emerging in the energy space.

Thank you very much for joining us today, Adam.

Adam Flikerski: You're welcome, Rob, and I'd like to thank you and the U.S. Bank team for hosting this topical and hopefully informative call today.

Rob Haworth: Thank you, Adam. Just so you all know, Adam is co-founder and managing partner of BlackGold Capital and he shares in all the investment decisions and day-to-day management of the firm. Adam has over 18 years of energy credit investment research and trading experience. Prior to founding BlackGold, Adam worked at Bear Stearns in New York as a high yield energy research analyst. He was promoted to Vice President and President at the age of 24 – one of the youngest members of the firm to earn that title. He's also been recognized by *Oil and Gas Investor* as one of the 20 under 40 in energy finance. Adam received his MBA from Harvard and is a graduate of McGill University.

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Before turning our conversation to Adam, please keep in mind the views he may express are his own or those of BlackGold Capital Management and do not necessarily reflect the opinions or positions of U.S. Bank.

So with that, let me get started. Adam, I can't thank you enough for joining us today to speak with our clients. Just to set the stage, if I think back a year ago, most energy analysts were projecting prices would be higher by the end of last year – by the end of 2015. Instead, here we are in March, and in January oil prices reached their lowest levels in more than a decade.

In the last couple of months, we've seen a rebound from those lows and many analysts are calling for prices to finish still higher this year in 2016. So if you could, open our conversation by reminding all of us what transpired in 2015 that really left prices at these still very low levels?

Adam Flikerski: Sure. Oil prices did decline starting in late 2014, 2015, as you mentioned, and into early 2016 as the oil supply and demand balance has taken longer than expected to occur.

There was a bit of a head shake in mid-2015 when oil went from $45 a barrel to $60 a barrel during a speculative rebound, which caused the capital markets to reopen and allowed companies to raise additional debt and equity capital to keep on producing, which therefore, extended and prolonged the cycle.

So that was certainly one factor. Another factor is that Saudi Arabia and OPEC (Organization of the Petroleum Exporting Countries) continued to produce all out in an effort to maintain market share and drive out higher cost production.

Third, U.S. dollar strength also played a significant role, in my opinion. As the Fed (Federal Reserve) has raised rates, countries around the world are devaluing their currencies to boost economies. This has put upwards pressure on the dollar and, therefore, downwards pressure on oil prices, which are obviously denominated in dollars.

So to recap on your question, oil prices fell by 31 percent in 2015 and 75 percent since the peak in June 2014. Over the past 30 years, only the 2008 decline of around 79 percent at the height of the financial crisis is of greater magnitude, and only the 1997 to 1999 timeframe decline is of greater duration.

The current oil price decline is similar to the shock that we saw in the mid-1980s, but there are also quite a few differences. For example, in the 1980s, OPEC's spare capacity was over 20 percent and global oil demand fell by 10 percent in advance of those price declines. Today, OPEC's spare capacity is near historical lows at less than 2 percent and global demand has reached new highs, having never declined throughout this downturn. So, as a result, I would say that we are seeing green shoots, if you will, as OPEC is getting more coordinated, U.S. production is starting to roll over and the Fed is backing off – or appears to be backing off-talks of additional rate hikes.

Rob Haworth: Thank you, Adam. That's an excellent summary of what's been going on and a tremendous decline – both in size and duration in terms of oil prices here lately.

Let's turn our attention instead to some of the capital markets, as you'd mentioned. With that big decline in oil prices since June of 2014 of 75 percent, we know we've seen energy equity sectors losing 50 percent to 60 percent over that same timeframe. And lately, we've seen a significant amount of announced job cuts, cuts in investment spending, cuts in oil rigs and many companies have even been cutting dividends.

Knowing you're an expert in credit, what has been the impact from that oil price decline on the credit market for energy debt over the same time horizon?

Adam Flikerski: The collapse that we've seen in oil prices has been historical. This is amongst the largest declines in oil that we've seen over the past 30 to 35 years. That has negatively impacted the value of virtually all energy assets – and for energy investors, there have been few, if any, places to hide.

Initially, the decline in oil prices impacted the highest cost in most leveraged energy companies. And that, afterwards, changed course in 2015 as the price of oil declined below the economic levels for a vast majority of the entire global energy industry.

So, I would start by saying equities, as a group, have performed the worst during this down cycle as they are obviously at the bottom of the capital structure. But there's no doubt that energy credit has suffered immensely as well. And that basically has declined the most in its history – even more than in 2008, and even 1998 when oil went to $10 a barrel.

If you look at various high-yield energy indices, they've declined by over 50 percent from their peak in June 2014. And some of the sub-indices have declined around 70 percent from their peak, but have rebounded somewhat with this recent oil price rebound.

I would also say, initially, the decline in energy credit was mostly concentrated to leveraged high yield issuers. But as commodity prices have continued to decline, the energy market stress has spread to all energy sub-sectors and ratings, including investment grade energy debt.

And so as a result, you've seen both high yield energy bonds and leveraged energy loans go to their most record highs – and once again, set even beyond the financial crisis of 2008.

Looking at it another way, what we've seen is, according to some analysts' work, the high yield energy market is currently pricing in around a 20 percent annual default rate over the next two years – roughly about 40 percent cumulative. By contrast, the high yield energy market, or default rate, peaked at around 13 percent in 1999 when oil went to around $10 a barrel.

Today, the market is essentially saying that four out of every 10 high yield energy companies will default over the next two years. Whereas, it was around, call it, one in 10 in 1999 when oil went to $10 a barrel.

As a result, in my opinion and based on our work, there are many energy credits in our universe that have nowhere near the kind of default risk being implied by the market and have a high probability of surviving.

Rob Haworth: That's a great point. Clearly there's quite a bit of cheapness in stock and bonds – kind of across the capital structure – as you pointed out. Both of those that would be the first to suffer pain in a default and even those that are of the highest quality and have the highest security in a company's capital structure are under some pressure.

I know one of the keys to getting out of this conundrum, from an investment perspective, is what happens to the price of oil going forward? Can some of this pressure be relieved? So, I guess I'll structure my question about energy prices this way. One, have we seen the low in oil prices? And two, what are your expectations for prices over the next couple of years – what might be an investment horizon?

And I think the implicit question in that – in some people's minds – is should I be worried about a $100 barrel oil sometime in the future? So with those couple of questions, I'll turn it back to you.

Adam Flikerski: Obviously the ultimate price of oil we'll know in hindsight, but I would say yes, I think that the lows are behind us in that we've already witnessed the second-largest and longest decline in oil prices over the past 30 years.

So, based on where prices are currently trading, those prices are unsustainable, in my opinion, in the long term because high cost producers are being forced out of the market and multi-year, even multi-decade, projects are being cancelled. There are some estimates that I've recently read from Wood Mackenzie, for instance, that suggested almost $400 billion in oil and gas projects have been delayed or cancelled since 2014.

If you look at global energy capital expenditures, they've declined 20 percent in 2015 and are expected to decline another 25 percent in 2016, which are the sharpest declines that we've seen since the 1980s. So, I also think that energy companies will continue to cut their cap ex budget as long as oil prices remain low. I think from that perspective, we're certainly seeing a self-correcting process take place, and I think that there's an old adage that talks about the lower the down, the higher the up. And I think that we're certainly seeing the seeds of that take place.

Number two, capital is just not available in the energy industry the way it once was, which is one of the main reasons why production was able to flourish, as I mentioned earlier. So, I think that when you take those two facts and you mix it together – as a result of low cap ex spending and less capital

being available – I expect a significant supply response to balance the market as the majority of the global energy industry is unprofitable at current commodity prices. So I think that a normalized price can ultimately rebound to that $50 to $60 range in the coming quarters due to a supply in cap ex, slowing production growth and, as I mentioned earlier, continued increases in global demand.

I think that if you look at cycles over the past 100-125 years, it's all about supply and demand equal liberating themselves, and I don't think that this cycle will be any different. And while we're still in a basing or bottoming process, I think risk, at these prices, is to the upside.

If you look at OPEC for instance, they're more coordinated now. I think they have all the elements in place for some sort of bottoming process, where I think risk is more to the upside than the downside at the current levels. Obviously, the big risk to a constructive view of that nature is if the capital markets get ahead of themselves and give these companies access to capital before the supply demand rebalancing process can fully run its course.

To your question about can we see $100 oil? Is there a possibility or a risk of $100 oil? I don't expect a return to $100 oil anytime soon without a geopolitical event. The collapse in oil prices has led to dramatic efficiency gains and has lowered the average breakeven price for many industry participants. And so, I think $50 to $60 oil should be sufficient for many U.S. producers of good quality assets to be the global swing producer for some time. So I think that $50 to $60 could be the old $60 to $70, if you will.

Last, I think that the industry has dramatically downsized, as we talked earlier. And unfortunately, a lot of talented people have left the industry. And so as a result, I think that while we may not see $100 oil anytime soon, I think it will actually take longer to rev back up as a lot of experienced and knowledgeable people have left the industry. I think that could cause oil prices to eventually overshoot to an upside based on fundamentals once the market recovers because it may take more time for the industry to play catch up.

Rob Haworth: So, $50 to $60 should be where we're headed – $100 is not likely and lots depends upon specific OPEC reactions and how much talent has left the industry. Let me take you a little deeper here, because we're going to get off this call and I'm going to sit at home and play armchair quarterback. What are the two or three things you're watching that may adjust your expectations for $50 to $60 a barrel that, if I'm the armchair quarterback at home, I can follow along?

Adam Flikerski: Sure, absolutely. A few things that I would suggest keeping an eye on: one is declining U.S. production. So, I would want to see U.S. production continue to decline from its previous levels of around nine or almost 10 million barrels a day. The main theme of this energy down cycle, at this point, has been about over supply and not demand destruction. So I'd like to continue to see U.S. supply come down. And, once again, the sharp drop in energy investments has

already led to a nearly 70 percent decline in the rig count in the United States. And U.S. production is down roughly 500,000 barrels a day from its peak.

Also, U.S. energy assets have extremely high decline rates – meaning that it's very much a treadmill phenomenon, where you have to pump a lot of cap ex dollars into these assets to keep production growing. And so, I think that based on the cap ex declines that we're seeing, there already are expectations for at least another 500,000 barrels per day of supply decline in 2016. So I think that the decline in production likely accelerates as long as prices stay low. And so I would continue to keep an eye on declining U.S. production.

Number two, I want to see not only declining U.S. production but I want to see declining OPEC and non-OPEC production. Over the past 18 months, the global oil market has been over supplied due to increased output from countries like Iraq and Saudi Arabia. I'd like to see is a continued slowdown in the rate of change of that output.

Saudi Arabia production, for instance, seems to be near its limits, from a production perspective, and Iraqi production growth is expected to slow this year as they reduce energy investments to reallocate capital towards military and domestic economic spending. As far as Iran is concerned, the expectation is for Iran to increase production by around 500,000 barrels a day in 2016 now that sanctions have been lifted, but expectations appear to be on the downside, given that there are several technical and regulatory challenges in ramping up production. So non-OPEC supply overall is expected to decline around 700,000 barrels a day in 2016 – and mostly as a result of declining U.S. production. Point number two is, I'd like to continue to see that rate of production growth slow for both OPEC and non-OPEC producers.

Third, OPEC coordination – I'd like to continue to see further OPEC coordination. We've all seen talks of a potential production freeze agreement that could take place in the coming months and that would be a good start.

Fourth, demand – increasing demand – that's an important one. I'd like to continue to see demand go up. Consensus global old demand growth is expected to rise by about a million barrels a day. As a result, I think the market has a good chance of rebalancing itself during the second half of this year as non-OPEC production declines and global demand increases and offsets any potential OPEC supply growth even though that may moderate.

I would say that overall, those are the main things that I would look for – for continued rebalancing and continued bottoming of the market.

Rob Haworth: So let me turn this to the dawn. It's been fairly dark in the energy industry – lots of struggles and certainly lots of uncertainties about where we go from here. But clearly there are opportunities to deploy capital and to invest money, with the potential for some positive returns, hopefully, in our future.

So thinking about that, how are you sizing up investment opportunities in the energy space and what's of interest to you?

Adam Flikerski: Yes, that's a good question and I always like to say that where there's crisis, there's also opportunity. The historical decline in the energy sector has created several dislocations and opportunities, where energy credit happens to be, in many instances, cheaper than energy equities.

And for the reason that I'll get into here shortly, I would make the case that energy credit – that expressing a constructive view on oil through credit and debt presents a potentially more attractive risk-adjusted return than other areas of the capital structure, or even being directly long the commodity.

So why is that? Well first, energy equities – this based on our work and the work of others – continue to price in a future oil price of around $65 a barrel. Whereas energy debt is pricing in a much bleaker scenario. So I think that's already a good place to start – which is, if one is to express a constructive view on the industry, buy energy securities that actually reflect low oil prices and energy debt fits that bill and checks that box.

Second, from an opportunity perspective, there are many instances where the debt of energy companies and the debt of MLPs (Master Limited Partnerships) or pipeline companies actually yields more than the equities themselves – yet the debt is obviously higher up in the capital structure stack and does not have the risk of any potential distribution or dividend cut.

As an example, let's look at Kinder Morgan, which is a blue chip MLP and considered one of the top midstream assets in the industry. Kinder Morgan equity yields around 3 percent. Now, let's look at some of its senior-secured first lien debt. That debt of Kinder Morgan yields around 11 percent. So this Kinder Morgan debt is higher up in the capital structure than the equity. It has no distribution cut risk and yet is yielding almost four times more than the equity. And that's the kind of relationship that historically has been the exact opposite, where the equity should yield a lot more than the debt, not vice versa.

So that comes back to my original comment where, in this instance, debt yielding 11 percent versus equity yielding 3 percent, to me, is a better risk-adjusted return conversation. Yet, despite these obvious advantages, the debt of a lot of these pipeline companies is trading at stressed, and in some cases distressed levels, due to sentiment and in-market fear for selling and that, in my opinion, presents an opportunity.

Third, as I mentioned earlier, let's go back to what the high yield or the credit market is currently saying. And the high yield energy market is, once again, currently pricing in around 20 percent annual default rate over the next two years, or 40 percent cumulative. By contrast, the high yield energy default rate peaked at around 13 percent in 1999 when oil went to $10 a barrel. And, may I remind you that, oil is currently in the high $30s today.

So basically, the market is saying, as I mentioned earlier, that roughly four in 10 companies in the high yield energy credit universe will default over the

next two years – whereas roughly around one in 10 defaulted in 1999 at much lower oil prices.

So as a result, in my opinion, based on the work we've done, there are many energy credits in our universe that have nowhere near the kind of default risk being implied by the market and that have a pretty good probability of surviving, which presents, in my opinion, an attractive risk-adjusted return opportunity. There's an opportunity to earn a solid cash yield while at the same time buying debt at a discount and earning potential capital gains from riding that up, as well as the cycle normalizes.

I think that overall, a significant deal of the downside in oil and gas energy credit has already been priced into the market and risk/reward is skewed to the upside – obviously assuming a sound underwriting process to make sure one owns the debt of good assets that can survive through the cycle.

Rob Haworth: Adam, thank you so very much for your time and insights on this topic, which has been a complex one for all of us as we've watched the energy industry unfold over the last two years. Thank you very much for joining us.

Adam Flikerski: You're more than welcome, Rob. I appreciate the time and once again, thank you to the U.S. Bank team for hosting this call.

Rob Haworth: Thank you. So the topics we've covered today may have important implications for your investment portfolios and I'll give you some thoughts in this regard. But I do want you to keep in mind that not all investment solutions or strategies that we've talked about may be appropriate or available to all our clients. So please speak with your U.S. Bank advisor. He or she will be happy to discuss your particular situation and how strategies may fit into your investment plan.

So a couple of the key messages that Adam provided us that I think are important. One, this has been an extended down-cycle in the oil market – both in terms of magnitude and time. As he noted, it's the second longest and the second largest in the last 30 years. So this is a bit of an unusual period. Some of what extended that was something like we saw in early 2015, with that early speculative rebound in prices that made capital – meaning companies were able to come back to the market to issue debt, issue equity, get more financing to continue to expand production in, what were then, higher prices. And that did prolong the growth in production cycle, certainly longer than most of us were thinking. And we think we're turning the corner on that.

As Adam noted, he thinks prices will be higher, but keep an eye on three things. One, what is happening with U.S. oil production. As Adam noted, U.S. domestic oil production is down about 500,000 barrels a day from its peak in the middle of last year. Oil production here in the United States flatlined at the end of 2015 – it’s started ticking down again. So keep an eye on U.S. oil production – that's going to be the key for rebalancing in this market. Two, watch the rate growth in OPEC and non-OPEC production. Those rates of growth should slow and that's something we're looking for. We think that will

happen. Three, you want to see OPEC continue to stay solid, meaning they should be coordinating themselves – probably won't see meaningful cuts, but you'll probably see constrained growth in OPEC and that's what you want to see.

So those are three keys all of us can watch for to see that the oil market is balancing like we'd expect. If I had to throw in one more thing, keep an eye on demand growth. It's been solid. That's unusual if you look at most over-supply situations Adam pointed out in the '80s. If you look at most over-supply situations, they've seen declines in demand. We've actually had stable demand growth. This period of over-supply is happening at a time of not great, but reasonable, global growth.

Last, as Adam pointed out, we've seen declines in both stocks and bonds for energy investors. But I would note that it looks like the opportunity is a little riper, in his view, on the credit side of the space. I thought one good example Adam brought up, basically for the next two years, is the prices in high yield energy bonds are reflecting 40 percent defaults. Historically, if you go back to 1999, it was 13 percent at the past peak. Adam probably doesn't see 40 percent of companies defaulting in the next two years. So, there may be some opportunity there.

As I wrap up, I would say those are really the keys. Oil prices are probably going to be a little bit higher – not a lot higher. They're going to stay lower for a little while longer. Keep an eye on production and get with your advisor to talk about opportunities in this space. We would certainly point you towards more active managers because this is a space where not all companies may be winners and you need to think about those opportunities very clearly.

I want to thank all of you very much for your relationship with us at U.S. Bank and for taking the time to attend our call today. Again, please do contact a U.S. Bank advisor if you'd like any more information on these or other timely topics. Thank you and goodbye.

Closing: Thank you for listening. We invite you to join us for future calls. Details can be obtained from your U.S. Bank representative.

Website: reserve.usbank.com

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