Energy: Recovery or Impaired? May 2020

OVERVIEW

- **Oil markets, already under stress prior to Covid19, have further struggled with the decline in demand resulting from global lockdowns**
- **Price weakness may finally force the industry to address the imbalance between production and profitability**
- **Opportunities are likely to be idiosyncratic as market stress creates winners and losers**

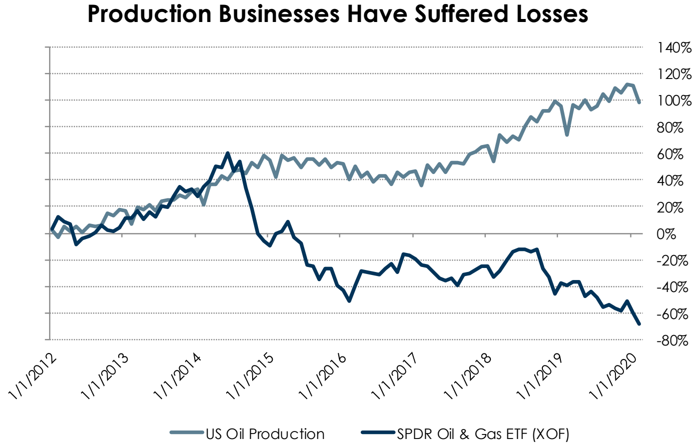
Background

Recent turmoil in oil markets brought new pain to investors hoping for recovery in the energy sector. As consumers have stayed home amidst the Covid19 pandemic, the resulting decline in oil demand has created new challenges for a market that was arguably already oversupplied with oil. Now the market is confronting the challenge of balancing demand with supply and storage capacity. WTI oil prices set records with negative prices in April, briefly dipping as low as -$40.32 per barrel, as investors pondered how much they might be paid to fill their swimming pools and bathtubs with oil. While the Covid19 pandemic will eventually end, investors must ponder whether the resulting impact is purely temporary, or whether demand decline could turn into some amount of demand destruction. Investors who sought to profit from recovery post the 2014/2015 energy drawdown did not get the recovery they imagined and the memory of that experience should and likely will inform investors' response to the current situation.

Misalignment of Supply

The US oil market prior to Covid19 was already a market that could be described as waiting for recovery. Under normal circumstances, an industry facing a decline in prices would be expected to reduce supply, but since the decline in oil prices in the latter half of 2014, the US oil exploration and production sector has not behaved in the normally expected manner, instead holding production mostly steady, and then increasing it even as profits declined. As production and profits have diverged, investors in the sector have not been rewarded to the degree they hoped, as they awaited a return to a more normal environment. A global price war in oil has created an unusual situation, with global producers in a seemingly never-ending quest to crush US shale producers, and the world wondering who might blink first.

US Oil Production Has Increased Even as Oil and Gas Production Businesses Have Suffered Losses

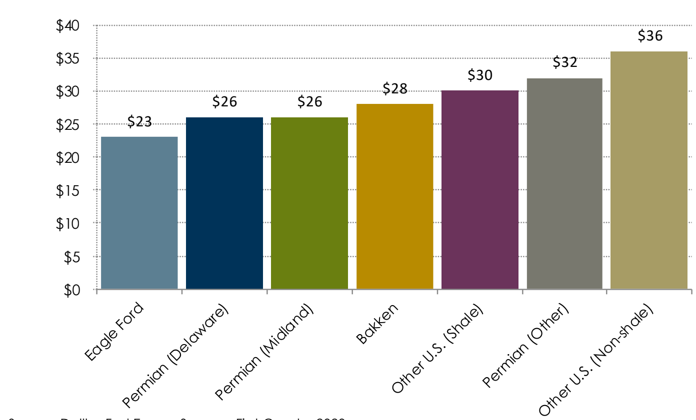


Source: Dow Jones, Morningstar, U.S. Energy Information Administration

Longer Term Implications

As global lockdowns ease and consumers begin to travel again, we would expect to see demand rise. There is a possibility though, that some of the demand reduction seen during Covid19 could have a longer-term impact. Newly increased comfort with video conferencing technology in the workplace and for community gatherings could replace some amount of daily commuter traffic and airline travel. Likewise, increasing investor interest in ESG investing may result in a lower cap on valuations for fossil-fuel related businesses as a portion of the investor-base excludes those businesses from their portfolios. November elections could lead to a change in the regulatory landscape, and the adoption path of electric vehicles creates additional uncertainty. A path forward from here would suggest that the industry needs to see some combination of reduced supply and increased prices to return to profitability. Recent survey data from the Dallas Fed indicates the median breakeven WTI oil price ranges from $23 - $36, so there is opportunity for profits at a number of producers. The upside for investors of this market turmoil and uncertainty is the potential for a new set of distressed investment opportunities that sees large established players purchase their weaker competitors' assets for pennies on the dollar.

Median WTI Oil Prices for Breakeven Production



Source: Dallas Fed Energy Survey – First Quarter 2020

ACG's Position

Recovery prospects across the oil industry are uneven and turnaround could be protracted as consumers' willingness to engage in previous patterns of consumption could lag the eventual transition away from Covid19 lockdowns. Industry hardship could create idiosyncratic opportunities as well-positioned businesses acquire discounted assets, but long-term questions of demand and production cost challenges will likely persist beyond a stabilization in oil prices. The addition of demand destruction caused by Covid19 to existing industry challenges has the potential to create winners and losers among the businesses competing in the space. This dispersion of outcomes could provide opportunities across credit, equities, and real assets. Investors interested in the energy sector would be best served by active managers who have the skills and expertise to separate the good from the bad.

Disclosures and Legal Notice

The views expressed herein are those of Asset Consulting Group (ACG). They are subject to change at any time. These views do not necessarily reflect the opinions of any other firm.

This report was prepared by ACG for you at your request. Although the information presented herein has been obtained from and is based upon sources ACG believes to be reliable, no representation or warranty, express or implied, is made as to the accuracy or completeness of that information. Accordingly, ACG does not itself endorse or guarantee, and does not itself assume liability whatsoever for, the accuracy or reliability of any third party data or the financial information contained herein.

Certain information herein constitutes forward-looking statements, which can be identified by the use of terms such as "may", "will", "expect", "anticipate", "project", "estimate", or any variations thereof. As a result of various uncertainties and actual events, including those discussed herein, actual results or performance of a particular investment strategy may differ materially from those reflected or contemplated in such forward-looking statements. As a result, you should not rely on such forward-looking statements in making investment decisions. ACG has no duty to update or amend such forward-looking statements.

The information presented herein is for informational purposes only and is not intended as an offer to sell or the solicitation of an offer to purchase a security.

Please be aware that there are inherent limitations to all financial models, including Monte Carlo Simulations. Monte Carlo Simulations are a tool used to analyze a range of possible outcomes and assist in making educated asset allocation decisions. Monte Carlo Simulations cannot predict the future or eliminate investment risk. The output of the Monte Carlo Simulation is based on ACG's capital market assumptions that are derived from proprietary models based upon well-recognized financial principles and reasonable estimates about relevant future market conditions. Capital market assumptions based on other models or different estimates may yield different results. ACG expressly disclaims any responsibility for (i) the accuracy of the simulated probability distributions or the assumptions used in deriving the probability distributions, (ii) any errors or omissions in computing or disseminating the probability distributions and (iii) and any reliance on or uses to which the probability distributions are put.

The projections or other information generated by ACG regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Judgments and approximations are a necessary and integral part of constructing projected returns. Any estimate of what could have been an investment strategy's performance is likely to differ from what the strategy would actually have yielded had it been in existence during the relevant period. The source and use of data and the arithmetic operations used for calculating projected returns may be incorrect, inappropriate, flawed or otherwise deficient.

Past performance is not indicative of future results. Given the inherent volatility of the securities markets, you should not assume that your investments will experience returns comparable to those shown in the analysis contained in this report. For example, market and economic conditions may change in the future producing materially different results than those shown included in the analysis contained in this report. Any comparison to an index is for comparative purposes only. An investment cannot be made directly into an index. Indices are unmanaged and do not reflect the deduction of advisory fees.

This report is distributed with the understanding that it is not rendering accounting, legal or tax advice. Please consult your legal or tax advisor concerning such matters. No assurance can be given that the investment objectives described herein will be achieved and investment results may vary substantially on a quarterly, annual or other periodic basis. There is no representation or warranty as to the current accuracy of, nor liability for, decisions based on such information.