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Drilling into CCC Energy

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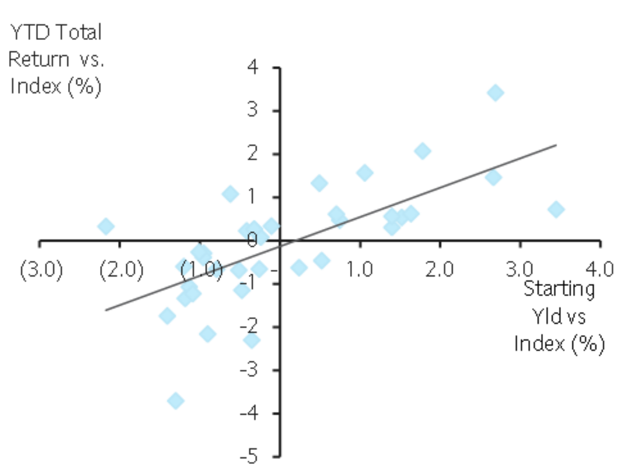
Last week, we noted that the dispersion of yields and returns has continued to decline through 2018. The US High Yield Index spread now sits modestly inside start-of-year levels, after approaching post-crisis lows almost 30bp tighter in April (see *Dealing with Disappearing Dispersion*). Combine that with a still-benign default backdrop, and Figure 1 confirms that higher starting yields have generally been correlated with leading performance this year despite plenty of single-name catalysts. There has been a similar observation when tracking performance by rating cohorts, with CCCs leading BB total returns by a sizable 3.4% year-to-date (see *CCCs Compression in Context*).

When constructing a 2018 returns forecast late in 2017, we predicted a modest 20bp of spread tightening for high yield in a year of sub-coupon returns. But our prior caution on lower-quality high yield as part of that 2018 forecast has not been justified thus far. Most notably, investors expect that the combination of tax cuts and fiscal stimulus will still drive growth and become more evident later this year. Also, the outsized increase in risk-free yields relative to our expectations in December has led investors to offset that continuing pressure with the higher starting yields and shorter duration of CCC paper.

This brings us to the energy sector specifically. It is difficult to make wide-ranging conclusions about the CCC segment, which is driven more by idiosyncratic credit risk stories, but CCCs have shrunk from 24% of the high yield market in 2009 to just 13% today, providing a positive technical in a market that is otherwise starved for distressed credit opportunities. But over that period, CCC rated energy credits have grown as a proportion of the high yield energy index (Figure 2), with the current split among E&P, oil field services, and midstream/refining at $19bn, $14bn, and almost $3bn, respectively. In addition, the E&P and oil field services subsectors rank among the largest cohorts within CCCs (12% and 7%, respectively, compared with healthcare at 14% and technology at 8%). As a result, the evolution of returns in energy will likely have an outsized effect on overall CCC returns in 2018, in our view.

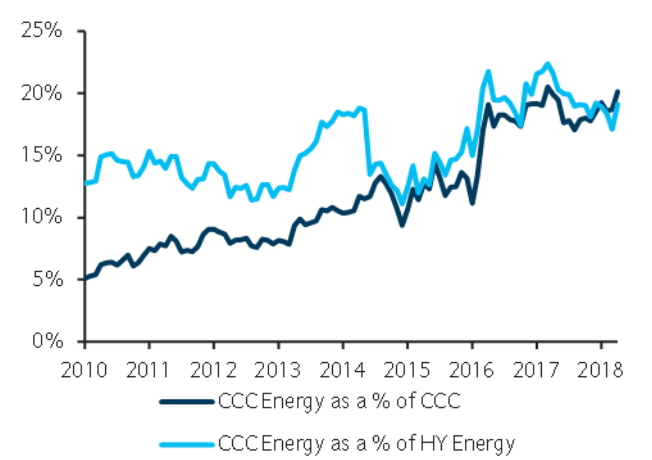
Perhaps most obviously, the sector has benefited from the current strength in oil prices. To assess sensitivity around current levels, Figure 3 suggests that with oil prices above the low $40s/bbl, we should expect little cause for alarm in CCC energy credit spreads broadly. The

FIGURE 1
Higher Starting Sector Yields, Higher Year-to-Date Total Returns versus Index



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 2
The Proportion of High Yield Energy That Is Rated CCC Has Grown, as Has the Proportion of CCC That Is Energy



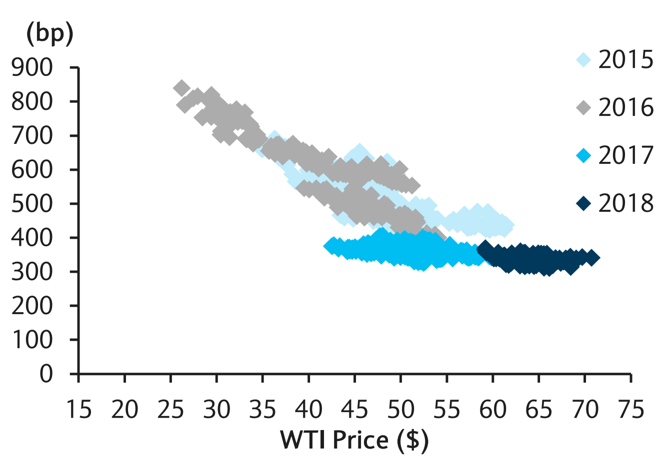
Source: Bloomberg Barclays Indices, Barclays Research sector has engaged in credit repair through equity raises and asset sales over the past few years, and weaker operators have defaulted or restructured since energy prices started moving lower in 2014. One pushback to a constructive view could be that CCC energy credits traded at wider levels in 2015, despite similar oil prices at times during 2017 and 2018. Digging deeper into this subset of CCCs, Paul Chambers, Barclays' high yield energy credit analyst, believes that if current oil prices hold (an outcome arguably not yet reflected in ratings), CCC rated energy credits as a percent of the overall high yield energy index could fall from 19% today to less than 10% as positive ratings pressure grows (detailed for specific credits below). Furthermore, we have viewed the limitation on interest expense deductibility as a challenge for the higher-leveraged portion of high yield, but the net effect on cyclical sectors, such as energy, could be mitigated because prior disallowed interest expense can be carried forward indefinitely under the revised tax code and utilized in a higher commodity price environment. That provision is an incremental pro-cyclical tailwind for the highly leveraged credits in energy, all else equal.

Looking at performance, in Figure 4, we find that of the 1.79% year-to-date total return for the US high yield Caa Index, 26% has come from the energy sector, whereas it represents 19% of the market value outstanding in the US high yield Caa index, at a yield-to-worst of 9.5%. Note that energy, across both the overall market and opposite ends of the high yield spectrum, has outperformed the index ex-energy. While the contribution of energy to overall CCC year-to-date returns is slightly higher than its contribution to the size of CCC risk, Paul continues to see value in the sector. He maintains an Overweight rating on the E&P and oilfield services subsectors, with summary views on select benchmark CCC energy credits included below:

Denbury Resources (DNR: Overweight): Denbury Resources lagged in 2017, given investors' perception of it as a leveraged, high cost operator. However, as new CEO Chris Kendall began implementing his cost savings initiatives, including an immediate cut in non-core capex, a different DNR began to emerge. Aided by higher oil prices and the widening of light to heavy oil pricing, approximately 65% of DNR's oil production is priced at a premium to WTI. In addition, asset sale initiatives and two secured exchanges have provided a near-term runway. As a result, DNR bonds have been top-performers within high yield. Paul's current net leverage estimate for 2018 is 4.0x (assuming 2018 average oil price of $61.50). His net leverage estimate for 2019 falls to 3.6x, assuming a $55/bbl oil price. If the current futures price for oil in 2019 is realized, his net leverage estimate would be approximately 2.5x, which is more akin to BB-rated credits within energy (see *1Q18 Beat; Growing EBITDA and Reducing Debt Like They Said They Would*).

FIGURE 3

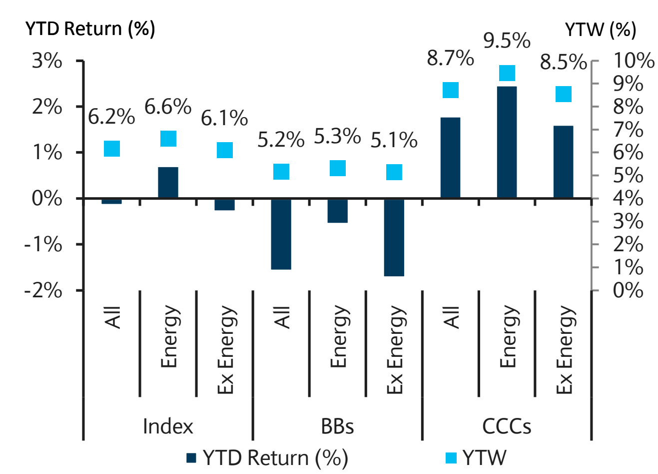
CCC Energy Now Less Sensitive to Lower Oil Than in 2015, as Balance Sheets and Costs Have Improved



Source: Bloomberg Barclays Live, Bloomberg

FIGURE 4

Comparing Current Yield-to-Worst and Year-to-Date Returns across Market Segments



Source: Bloomberg Barclays Live

Parker Drilling (PKD: Overweight): The company's core US business, rental tools, has experienced meaningful growth in 2017, and Paul expects this to continue in 2018, although he expects some pressure on margins. However, PKD's international operations (including Alaska) are experiencing exceptionally low utilization. But Paul expects this to change during 2H18 and 2019, resulting in a net improvement in credit metrics. His optimism comes from a return in international land drilling activity, which peers NBR and KCA Deutag have recently highlighted as probable during 2018. Chambers also notes that PKD's domestic barge drilling business, which contributed more than $70mn in gross profit in 2014 (compared with entire company gross profit of $90mn in 2017) remains mostly a dormant business. A potential revival in this segment could provide an attractive option if oil prices increase (see *1Q18 Disappointing - Optimism Remains for an International Recovery Starting in 2H18 but 2022s Do Not Reflect It*)

EP Energy (EPENEG: Overweight structure except 9.375% 2024s at Market Weight): Paul Chambers thinks that management could monetize its Wolcamp and Altamont acreage at attractive levels over the next 12-18 months. From the 1Q earnings report, cash margins of $15.87/boe were the highest in several years, and Eagle Ford production was up 17% q/q. Paul believes that EPENEG would be free cash flow positive at current futures prices for oil in 2019, as management expects to be 70-75% hedged for 2019 by the end of this year. In the meantime, discussions with RBL lenders about a maturity extension are progressing, and the company still expects to complete them by the end of 2Q18. For 2019, assuming $55/bbl oil, Paul sees net leverage closer to 5.7x, but the current 2019 futures prices for oil and gas would result in a net leverage estimate of approximately 4.4x (see *1Q18 In Line; Adding Hedges as Creditors Wait Patiently for Asset Sales to Emerge*).

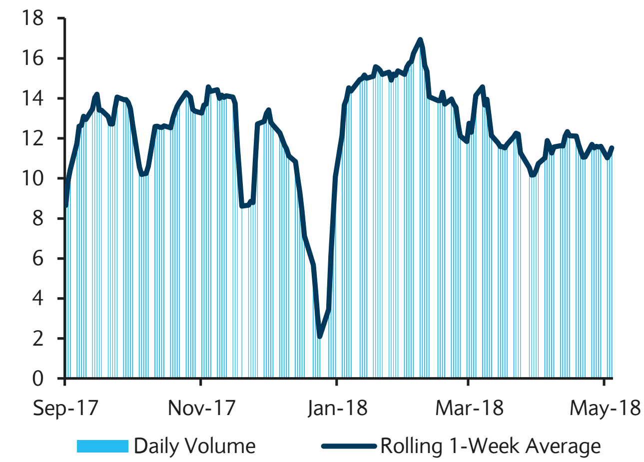
Sanchez Energy (SN: Market Weight): SN reported a weak 1Q, missing EBITDA consensus by 5% while lowering 2018 guidance. Higher cash costs and much lower NGL realizations are among its current challenges. Ongoing operational issues, a lack of announced assets sales, and disappointing UnSub cash flow remain hurdles for the company, but current valuations of $68/69 for the 6.125% 2023s appear fair to Paul. Management is targeting cash flow neutrality for 2019 or 2020. For 2019, assuming $55/bbl, Chambers sees net leverage of 5.3x (versus 4.9x for 2018), but realization of the current strip for 2019 would result in a drop in net leverage to 4.2x (see *1Q18 Miss – Still Challenged Even with Higher Oil Prices; the Bond Market Has It Right)*.

Halcon Resources (HKUS: Market Weight 6.75% 2025s): HKUS is adapting its strategy by expanding its Permian footprint by almost 60k net acres, with leverage drifting higher as well. 1Q EBITDA missed consensus estimates, and the company recently received an increase in its secured revolving credit facility of $100m. Paul believes that HKUS will need another $100m within the next 12 months or else will have to raise equity given its current spending plans. As a result, he sees net leverage rising from 1.6x to 3.5x by YE18, falling back only slightly, to 2.9x, by YE19 assuming oil at $55/bbl. At the current strip, net leverage would be closer to 2.6x (see *1Q18 Slight Miss; Still Land Grabbing)*.

Weatherford (WFT: Market Weight): WFT reported a good 1Q, with some early signs of the benefits of cost savings initiatives and an uptick in international operations. In the meantime, credit investors are focused on asset sales, given its free cash flow burn of $211m in the quarter. Management reiterated its target of reducing net leverage by half by YE19, aiming for free cash flow that is neutral this year and positive in 2019. Paul believes that WFT should be a prime beneficiary of the recovery in international upstream spending in 2H18 and 2019, but a stacked debt maturity schedule through 2025 and lack of robust and consistent free cash flow generation, as well as a drawn-out asset sale process, leave him favoring the PKD 6.375% 2022s (Overweight) over the WFT 8.25% 2023s (see *1Q18 – Good Operational Progress but Overshadowed by Outsized FCF Burn and Continued Lack of Asset Sales*).

MEG Energy (MEGCN: Underweight): Paul believes that MEG Energy is a good long-term story, with added pipe capacity from Flanagan South and Seaway starting in mid-2020, but feels that the bonds are mispriced over an interim period, as he sees potential challenges ahead with higher costs per barrel (including transport), uncertainty about forward WTI-WCS differentials, a high cash burn through 2019, and the potential for oil prices to decline in 2H18. At $55/bbl, Paul sees MEGCN's net leverage at 7.6x, but declining to 5.1x in 2019 with a $60/bbl oil price assumption. Chambers does note, however, that utilizing the current 2019 oil futures of approximately $65/bbl, MEGCN's net leverage would be a more attractive 3.8x and the bonds would have room to tighten from here. Core to Paul's view is the unsustainablity of current elevated oil prices, and he thinks the MEGCN 2023s/24s are mispriced as result (see *Higher Oil Can Make a Difference but We Remain Underweight with $55/bbl Longer Term*).

High Yield Average Institutional Trade Volume ($bn)

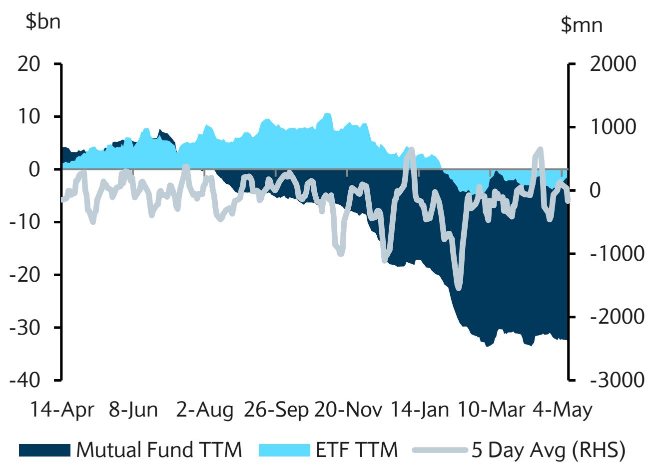


Note: Includes both registered and 144A volumes. Source: FINRA TRACE

On-the-Run HYCDX versus US High Yield Index (bp)

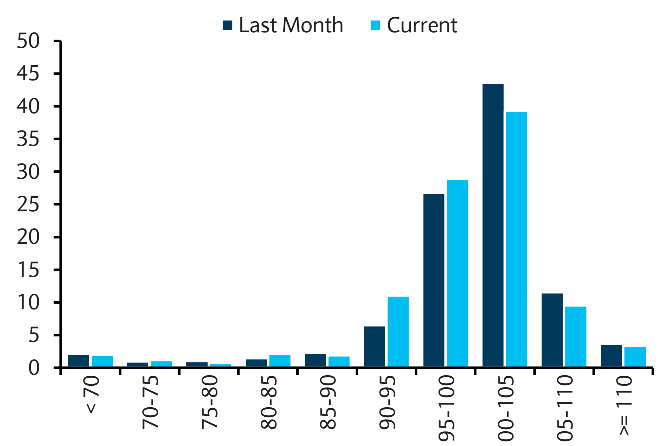
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



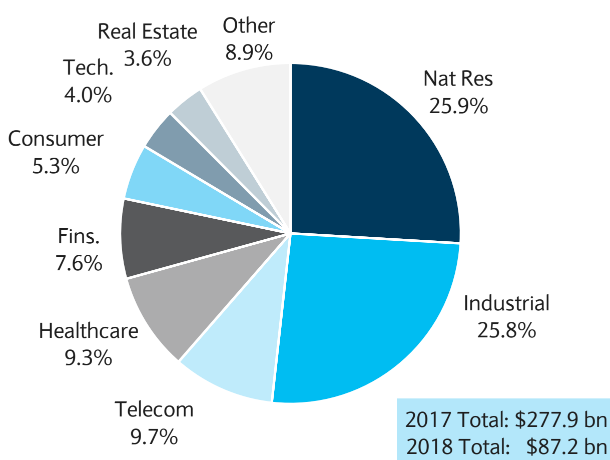
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



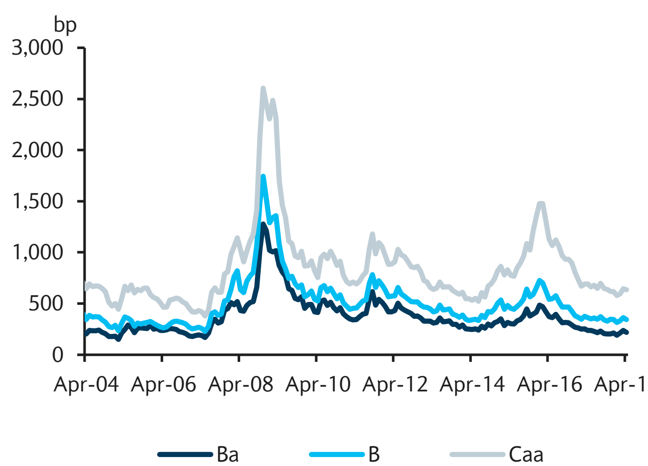
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

Analyst Certification

We, Paul Chambers, Rizwan Hussain, Arvind Kumar, Bradley Rogoff, CFA and Scott Schachter, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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Materially Mentioned Issuers/Bonds

DENBURY RESOURCES INC, CD/CE/FA/J
DNR 4 5/8 07/15/23, Overweight (USD 87.00, 09-May-2018)
DNR 5 1/2 05/01/22, Overweight (USD 90.75, 09-May-2018)
DNR 6 3/8 08/15/21, Overweight (USD 94.50, 09-May-2018)
DNR 9 05/15/21, Overweight (USD 106.00, 09-May-2018)
DNR 9 1/4 03/31/22, Overweight (USD 106.00, 09-May-2018)

EP ENERGY LLC / EVEREST ACQUISITION FINANCE INC, CD/J
EPENEG 8 11/29/24, Underweight (USD 103.75, 09-May-2018)
EPENEG 6 3/8 06/15/23, Overweight (USD 59.50, 09-May-2018)
EPENEG 7.75 09/01/2022, Overweight (USD 56.00, 03-Jan-2018)
EPENEG 8 02/15/25, Overweight (USD 76.00, 09-May-2018)
EPENEG 9 3/8 05/01/20, Overweight (USD 97.25, 09-May-2018)
EPENEG 9 3/8 05/01/24, Overweight (USD 83.00, 09-May-2018)

HALCON RESOURCES CORP, CD/CE/D/FA/J/K/L/M
HKUS 6 3/4 02/15/25, Market Weight (USD 98.25, 09-May-2018)

MEG ENERGY CORP, CD/D/J/K/L/M/R
MEGCN 6 1/2 01/15/25, Underweight (USD 101.00, 09-May-2018)
MEGCN 6 3/8 01/30/23, Underweight (USD 92.50, 09-May-2018)
MEGCN 7 03/31/24, Underweight (USD 92.50, 09-May-2018)

PARKER DRILLING CO, CD/CE/D/J/K/L/N
PKD 6 3/4 07/15/22, Overweight (USD 74.50, 09-May-2018)
PKD 7 1/2 08/01/20, Overweight (USD 94.50, 09-May-2018)

SANCHEZ ENERGY CORP, CD/CE/FC/J
SN 6 1/8 01/15/23, Market Weight (USD 68.75, 09-May-2018)

SN 7 1/4 02/15/23, Market Weight (USD 100.25, 09-May-2018)
SN 7 3/4 06/15/21, Market Weight (USD 89.50, 09-May-2018)

WEATHERFORD INTERNATIONAL LLC, A/CD/D/J/K/L/M/N
WFT 6.8 06/15/37, Market Weight (USD 78.50, 09-May-2018)
WFT 9 7/8 03/01/25, Market Weight (USD 99.63, 09-May-2018)
WFT 6 1/2 08/01/36, Market Weight (USD 78.00, 09-May-2018)

WEATHERFORD INTERNATIONAL LTD, CD/D/J/K/L/M/N
WFT 4 1/2 04/15/22, Market Weight (USD 91.00, 09-May-2018)
WFT 5.125 09/15/2020, Market Weight (USD 99.63, 09-May-2018)
WFT 5.95 04/15/42, Market Weight (USD 74.75, 09-May-2018)
WFT 6 3/4 09/15/40, Market Weight (USD 78.00, 09-May-2018)
WFT 7 03/15/38, Market Weight (USD 79.00, 09-May-2018)
WFT 7 3/4 06/15/21, Market Weight (USD 101.00, 09-May-2018)
WFT 8 1/4 06/15/23, Market Weight (USD 97.00, 09-May-2018)
WFT 9 7/8 02/15/24, Market Weight (USD 100.25, 09-May-2018)
WFT 9 7/8 03/01/39, Market Weight (USD 97.00, 09-May-2018)

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to exceed the six-month total return of the relevant index.

Market Weight (MW):
For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be in line with the six-month excess return of the relevant index.
For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be in line with the six-month total return of the relevant index.

Underweight (UW):
For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be less than the six-month excess return of the relevant index.
For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be less than the six-month total return of the relevant index.

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Overweight (OW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to exceed the six-month expected excess return of the relevant sector.
Market Weight (MW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be in line with the six-month expected excess return of the relevant sector.
Underweight (UW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be less than the six-month expected excess return of the relevant sector.
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Market Weight (MW):
The analyst expects the three-month excess return of the country's index eligible bonds to be in line with the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
Underweight (UW):
The analyst expects the three-month excess return of the country's index eligible bonds to be less than the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
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