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Glass half-full

A crude-oil pandemic overlaid on the viral one claimed a new casualty on Monday with the bankruptcy filing of Diamond Offshore Drilling, Inc. No need, nowadays, to go looking for oil under the sea when desperate futures traders will pay you to take it off their trembling hands. All of which, as noted two weeks ago in these pages, is bullish for natural gas—and, as we will now propose, for a selection of gas-related securities.

When the price of crude oil topped out six years ago, gas had already been in a four-year downtrend. "The gas market in the U.S. has been in a terrible bear market for a decade, but it hasn't been because of demand," Adam Rozencwajg, managing partner at Goehring & Rozencwajg Associates, LLC, tells colleague Evan Lorenz. "Demand has been really strong, having grown about 30% over that time from 65 billion cubic feet per day to 85 bcf/d. It's a really fast rate of growth, but supply just completely overwhelmed it.

"Supply has gone from 58 bcf/d to 92 bcf/d, an increase of 60%—pretty incredible considering we were worried about running out of gas in the middle part of the last decade," Rozencwajg goes on. "And of that increase of 34 bcf/d, 20 has been from the Marcellus and 20 has been from associated gas." Because 20 plus 20 makes 40, it's clear that non-shale production is shrinking.

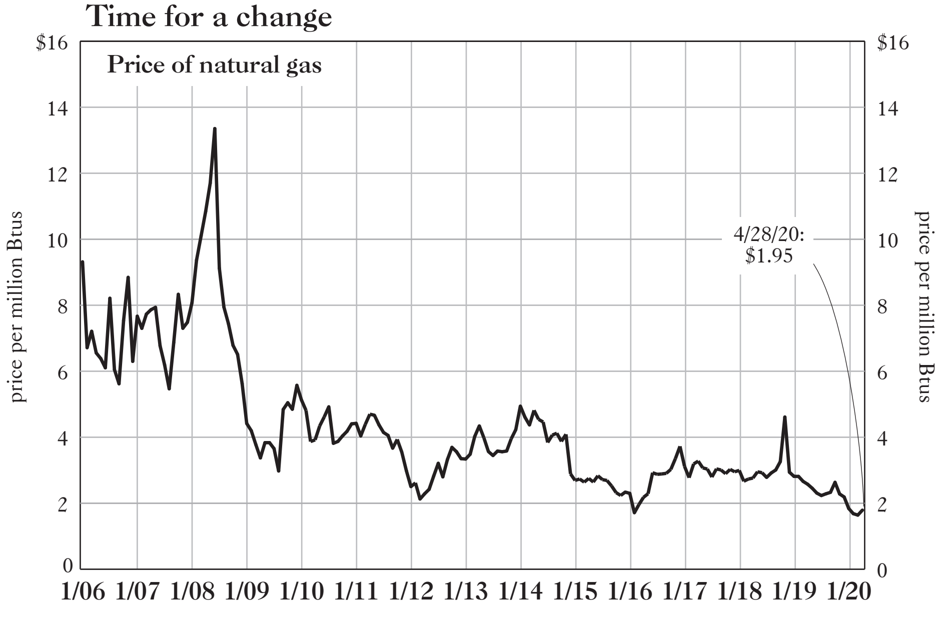
Production in the Marcellus Shale, which ranges from the eponymous New York town into the Appalachian Basin, peaked in November, coincident with the cutbacks in oil drilling. Given today's prices, signs abound that the decline is likely to continue. On Monday, for example, CNX Resources Corp. (CNX on the New York Stock Exchange) cut production guidance for 2020 by 5.6%, to 510 billion cubic feet equivalent, and laid out its revised long-term capital plan. The intention now, between 2022 and 2026, is to drill just 25 wells a year, down from the 84 and 76 wells sunk in 2018 and 2019, respectively.

Gas extracted in pursuit of oil, so-called associated gas, is the other big contributor to today's glut. To oil men, the methane that comes up through the borehole is as free as the air. They produce it by accident, and they'll produce none of it if they can't lift oil at a profit. Given that drillers on average need $47 a barrel to generate a profit, according to the April 7 survey of energy producers by the Kansas City Fed (respondences ranged between $25 to $65 a barrel), it seems that just about no one is making money lifting crude.

The general business component of the Texas Manufacturing Outlook Survey, released Monday by the Dallas Fed, highlights the bearish ripples from the collapse. The index plunged to negative 73.7 in April, an all-time low, from negative 70 in March. "Oil companies are all now in survival mode, from the smallest to the largest," the report quotes a machinery maker as saying. "And that has really hurt our plans, from paying off debt to buying new equipment."

Then, again, oil's pain may be gas's gain. "While near-term gas market fundamentals remain challenged due to Covid-19 related demand concerns and a warm 2019–20 winter season,

Time for a change



source: The Bloomberg

we do see the supply/demand balance tightening in 2H20 on sharp associated gas declines," to quote an April 20 JPMorgan analysis. "Oil curtailments, which are likely to accelerate over the next couple of months could improve the situation for gas prices materially, and we've seen recent strength in the front end of the curve."

"Of course," Lorenz observes, "no decade-long bear market would be complete without flashes of false hope. Weather, too, plays its role in gas demand. A cool summer and a temperate winter can blunt the improved supply outlook, and a rapid recovery in the price of oil could lead to an upsurge in production in the Permian and the concomitant return of associated gas."

How to play a potential gas rally? "I own CNX and Cabot Oil & Gas [COG on the Big Board]," Mat Klody, chief investment officer of Keebeck Wealth Management, tells Lorenz. "COG is an equity that is beat up a lot but has outperformed significantly over the last two months. It is a low-cost producer with a decent balance sheet. I own the equity of those guys. I also own the Range Resources debt, the 2025s."

By the numbers, at 38.6 times trailing earnings and 28.5 times the 2020 estimate, CNX hardly looks like a bargain, but a heftier gas price could change facts and perceptions alike. On the first-quarter earnings call, management vowed to reduce debt—as of March 31, net indebtedness amounted to two times trailing earnings before interest, taxes, depreciation and amortization. The company has used its cash to retire $71 million's worth of senior secured 5⅞% notes due 2022 at an average price of $85.

"CNX is about optimizing the long-term [net asset value] per share," CEO Nicholas Deluliis told analysts on the same call. "And the single biggest financial tool that we have at our disposal... is to generate free cash flow across our companies on a consolidated basis." In the three months till March 31, CNX delivered $115.3 million in free cash flow; management forecasts $300 million this year, $400 million in 2022 and an average of $500 million annually from 2022 to 2026. For perspective, CNX's market cap stands at $2 billion.

Cabot is the class of the industry, both by our lights and JPMorgan's. Thus, according to the Morgan analysts, Cabot has "one of the strongest balance sheets in the space" and "is the dominant player in the core of the Susquehanna County, which features among the lowest finding costs (~$0.26 [per thousand cubic feet]) and the highest returns of any shale-gas asset in the United States."

As of Dec. 31, Cabot's net debt weighed in at 0.7 times trailing Ebitda. Last year, the company generated $657.4 million more in cash from operations than it paid in capital expenditures, a sum equivalent to 8% of the current market cap. At 12.7 times trailing earnings and 34.5 times the 2020 estimate, the shares are not visibly cheap. However, as the Morgan team estimates, for every 10-cent increase in the price of gas, Cabot's free cash flow will rise by $80 million.

Unlike CNX and Cabot, Range Resources is not now generating positive free cash flow, having laid out last year $5.4 million more on capital investment than it generated in cash flow from operations. And if Street estimates are on the beam, free cash flow will dwindle to negative $63.6 million in 2020. As of Dec. 31, Range showed net debt amounting to 3.6 times trailing Ebitda. While none of the trio of oil drillers is fit for widows and orphans, even cycle-hardened speculators may give Range common a pass (for the record, it's RRC on the Big Board).

Which brings us to Range's single-B-plus-rated 4⅞s of May 2025, quoted at $73.63. If the price of natural gas rallies by as little as 25 cents, the bonds ought to be money good, and the speculating owner would be looking at a yield to maturity of 12%. If the prolonged bear market in gas causes Range to file for bankruptcy, the potential recovery on the bonds looks promising, since they sit at the aforementioned 3.6 times Ebitda. "I think one is buying this security at three to four times weak [natural] gas priced Ebitda," Klody explained via email. For the bold and bullish.

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