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Massive oil spill

Evan Lorenz writes:

"If someone said the global economy just hit a wall and here are the five reasons why," says a manager of an energy-focused hedge fund, "I could understand a $25 decline in crude oil. That hasn't happened." Explicable or otherwise, West Texas intermediate is 29% lower since the close of the third quarter.

Now under way is a speculation on a non sequitur. The lurch lower in crude has repriced the energy sector as if for recession. Yet the S&P 500 still trades at 18.4 times trailing earnings on near all-time-high profit margins. Perhaps the stock market is late in getting the cyclical memo. Or maybe China is finally coming a cropper and the Oil Patch got the news first. Or perhaps the price of oil fell out of bed and will shortly climb back in. We're on firmer footing in observing that there are some very cheap energy stocks, among them pipeline companies (SemGroup Corp., Delek Logistics Partners L.P.) and coal miners (Hallador Energy Co., Alliance Resource Partners).

You could say that the overworked phrase "perfect storm" has at last found a defensible use. On May 8, President Trump slapped sanctions on Iran effective Nov. 4. It seemed reasonable to suppose that the oil market would soon be short the one or two million barrels a day that Iranian exports would no longer provide. Things turned out very differently, as commodity investors Goehring & Rozencwajg Associates, taking up the bearish narrative, explain:

> Saudi Arabia, responding to a series of tweets from the President among others, decided to act in its unofficial role as swing producer. Immediately following the announcement of sanctions in May, Saudi Arabia increased production from 9.97 mbpd to 10.68 mbpd in October. Since the Iranian sanctions were not due to start until November, total OPEC production increased by a very large 1.5 mbpd over that same period.

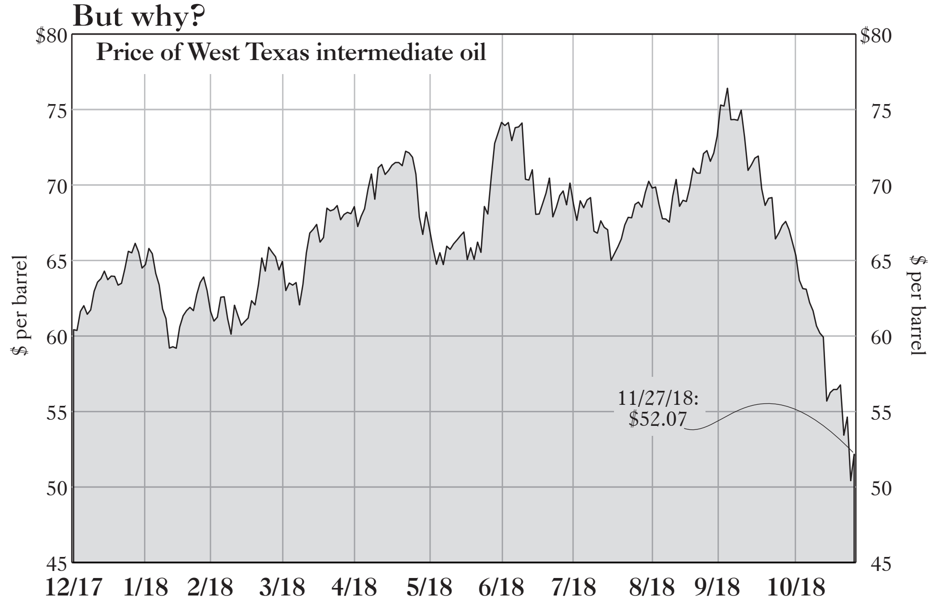
Thus did OPEC push the world into a net oversupply from a net undersupply. From the start of the year through Sept. 14, U.S. crude inventories (excluding the Strategic Petroleum Reserve) registered a net decline of 30.3 million barrels. From Sept. 14 through Nov. 16, U.S. inventories have bulged by 52.8 million barrels.

On Nov. 2, the president granted waivers to continue purchasing Iranian oil; the market didn't need the cushion after all. The recipients, China, India, South Korea, Japan, Italy, Greece, Taiwan and Turkey, collectively accounted for three-fourths of Iran's oil sales. Hedging activity added its manic zest to the sell-off. On Nov. 13 alone, West Texas intermediate plunged by 7.1%, capping off 12 consecutive negative trading sessions, a record.

OPEC, set to meet on Dec. 6 in Vienna, is expected to agree on new production cuts. Even so, according to Bloomberg, investors are paying the highest prices to protect against further declines in at least five years, including the annus horribilis, 2014.

Then, again, low prices are a widely prescribed elixir to fix the problem of

But why?



source: The Bloomberg

low prices. One could venture that, based on rig counts, the level of well completions and initial production rates, America's Permian Basin will prove less productive than many suppose. Besides, the shale sector is still smarting the 2014–16 collapse. In the past four years, producers have focused on lowering their breakeven costs and increasing their cash flows. In 2014, shale giants Chesapeake Energy Corp., Anadarko Petroleum Corp., Apache Corp., EOG Resources, Inc. and Continental Resources, Inc. spent $7 billion more on capital expenditures than they generated in cash from operations. In 2018, the Street expects the five to generate $3.7 billion in positive free cash flow.

But it's the demand side of the oil-price equation that holds the greater risks. In 2017, according to the U.S. Energy Information Administration, China imported 8.4 mbpd of oil, overtaking America's 7.9 mbpd of imports. On the authority of *Grant's Interest Rate Observer*, the mainland poses the biggest risk for an unscripted macroeconomic slowdown.

Not that China's official statistics would likely be of any help in calling the turn. Real Chinese output rose 6.5% year-over-year in the third quarter, only a slight miss to expectations of 6.6%, Beijing says. New housing starts rose an astonishing 20% year-over-year in September. While the 8.6% year-over-year growth in retail sales missed expectations of 9.2% growth in October, the 5.9% year-over-year rise in industrial production surpassed estimates of 5.8% in the same month.

Neither should one look to China's too-big-to-fail banks for an early warning sign. China Construction Bank Corp., Industrial & Commercial Bank of China Ltd., Agricultural Bank of China Ltd. and Bank of China Ltd., collective holders of $13.9 trillion in assets—the world's largest banks by size—are not only too big to fail but also, perhaps, too big to acknowledge the possibility of failure. With an average tier-1 ratio of 12.7% and a nonperforming loan ratio of 1.5%, they are ostensibly worry-free.

Carl Walter, co-author, with Fraser Howie, of *Red Capitalism*, says he recently bumped into a senior examiner at the China Banking Regulatory Commission. "You guys did a real good job of keeping these big four banks clean," Walter complimented the mandarin. "The guy looked at me and said, 'Yep, we did. The cost was to push it out somewhere else.'"

"If you look at the big four banks' NPLs or capital ratios, they all look fantastic," Walter goes on. "If you look elsewhere, it is not such a great story. Like the wealth management products. Those things are going to disappear. Or the trust companies. Or these funds that they have out there. Or all these stupid asset managers—there are [about] 37 asset-management companies now. It is hard to keep track of what the hell is going on the ground right now and who owns this. The smallest banks are the ones that grew fastest in the last decade, and they don't have any deposits."

Never above suspicion, China's economic data are even less reliable than usual this year, according to Anne Stevenson-Yang, co-founder of J Capital Research. "Steel production is supposedly up almost 8% year-to-date. In reality it is down 1% year-to-date," she says. "That is confirmed by a lot of different things, from iron-ore imports to pig-iron production to interviews with people. When have you ever had 6.5% growth with negative 1% steel production?"

The fifth of the economy tied to real-estate development is a particular worry. When turned away by the banks, property developers had recourse to China's shadow finance market. But since the late 2016 crackdown on the shadow financiers, the developers, increasingly, have had nowhere to turn. The credit crunch described by Logan Wright at the *Grant's* Fall Conference is the upshot (see the issue dated Oct. 19).

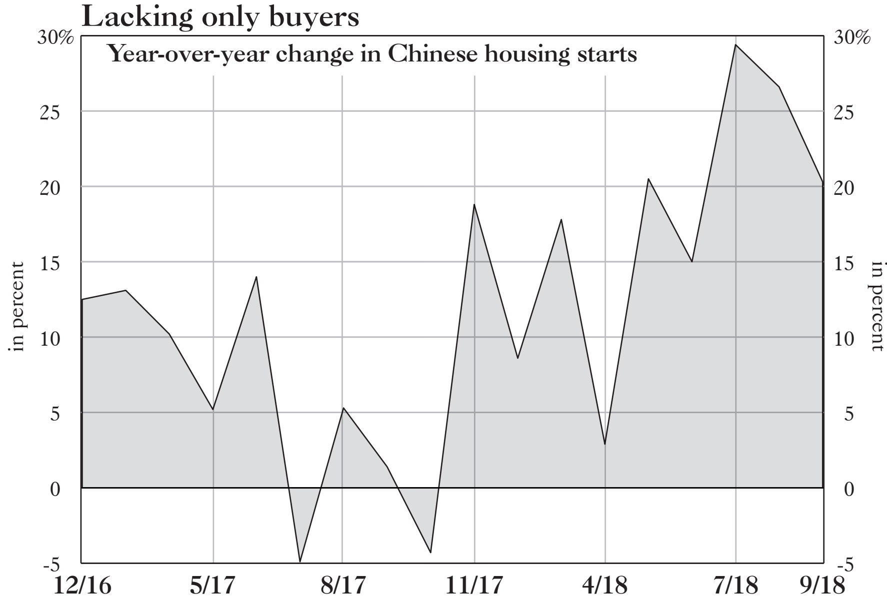
"That is why you see all this increase in new starts," Stevenson-Yang explains. "It looks like the property sector is growing apace, but in reality they don't have loans from the shadow sector, so they need to drive cash flows otherwise, so they need pre-sales licenses." Selling incomplete units to fund the building of more incomplete units would appear to be the business model.

Still and all, according to Leigh Goehring, "Chinese-oil demand has been revised up almost 200,000 bpd already in 2018. That extends up the whole upward revisions over the last 12 years." It wouldn't be the first time a heavily encumbered Asian economy continued to buy oil even after its financial music stopped. Following the year-end 1989 peak in the Nikkei index, Japanese crude consumption rose each year for the following half-decade, the near standstill in nominal GDP growth notwithstanding.

Anyway, portions of the energy sector look cheap. One valuation standard, and a reasonably conservative one, is called PV-10. It's the present value of after-tax cash flows from proven reserves (i.e., reserves with a greater-than-90% chance of being recovered) discounted back at a 10% rate.

"We computed an index of 29 U.S. oil-focused E&P companies that have a

Lacking only buyers



source: The Bloomberg

combined enterprise value of $435 billion," says Adam Rozencwajg. "These companies have averaged an EV/PV-10 ratio of 2.6 times over the past ten years, and today we estimate they trade for only 1.8 times, representing a nearly 35% discount to their long-term valuation."

"If oil prices returned to $75 per barrel (a level last seen only six weeks ago, mind you), our index would have an enterprise value of only 1.1 times its current proved-reserve PV-10," he continues. "Not only is this the lowest level in the [roughly] 20 years of data we maintain, but it is approaching 1.0 times, which would be the discounted cash-flow valuation, assuming nothing is drilled other than proved undeveloped reserves. Talk about getting the upside for free."

Discounts are even greater in the private markets, according to Peter Leidel, a general partner in Yorktown Partners L.P., an energy-focused private-equity fund: "The one area of the market that is cheap is mature conventional oil and gas production. There are hardly any buyers for it. The natural buyers would have been the upstream MLPs, all of which went bankrupt. There are no bids for those kinds of assets. So, we have companies that are buying that and just running the assets for the cash flow. We don't know who would buy it from us, so we'd only do it if we can get a three-year or shorter pay-back, i.e., get our money back in three years."

The dynamics of passive investing played their part in the liquidation, too. On Nov. 14, 24 hours after the 7% down day in oil, natural gas shot higher by 18%. (A warm summer and cold snap at the start of winter caused U.S. natural-gas inventories to contract by 16% year-over-year in the week ended Nov. 16.) Yet, on Nov. 14, the share price of Antero Resources Corp., a shale giant that produced the equivalent of 250 billion cubic feet of gas in the third quarter, actually fell—coincidentally, by 7%.

We suspect that Antero, a constituent in a number of exchange-traded funds, was in the wrong place at the wrong time, that place being the ETF portfolios. The share price cratered as speculators cut "exposure" to the crude market by dumping the funds in which Antero was an innocent constituent member. Oil? Gas? It's all the same when you sell the iShares U.S. Energy ETF.

The indiscriminate nature of the sell-off means that investors don't have to turn to E&P companies, which have the most exposure to swings in commodity prices, to find potential bargains. Pipeline companies, toll-takers without undue business volatility (their share prices are a different story), have been washed out with the rest. Thus SemGroup (SEMG on the New York Stock Exchange) and Delek Logistics Partners L.P. (DKL, also on the Big Board), past clicks-to-pick, have dropped by 48% and 5.4% since the start of the year and are priced to yield 11.9% and 10.5%, respectively (*Grant's*, March 9).

With the purchase last year of the Houston Fuel Oil Terminal Co. for $1.5 billion in cash and stock, SemGroup got a presence on the Houston ship channel, but at the cost of an untimely bump in leverage. The debt came aboard as profits swung to losses in the corporate supply and logistics division, which buys oil in the spot market to sell to refiners.

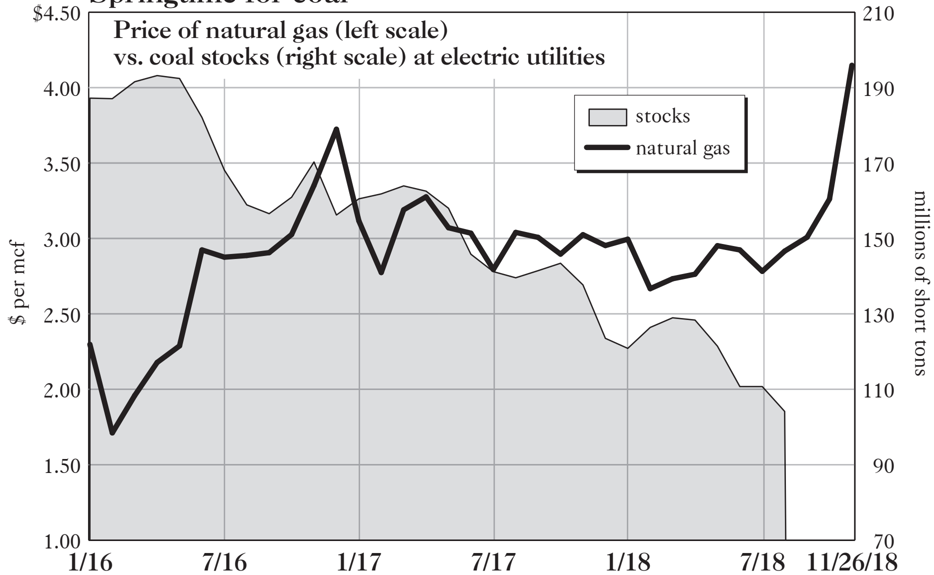
Addressing both problems, SemGroup sold a 49% interest in its Maurepas Pipeline in October for $350 million to funds managed by Alinda Capital Partners. After giving effect to the transaction, net debt will decline to 5.4 times earnings before interest, tax, depreciation and amortization from 6.4 times (and from 4.4 before the Houston Terminal acquisition). While adjusted EBITDA grew by 6.3% to $96.4 million in the third quarter, operating losses in the S&L group increased to $7 million from $1.7 million. The segment is still working off take-or-pay agreements but is closing in on breaking even, CFO Robert Fitzgerald said on the Nov. 8 earnings call.

"We think [SemGroup] is going to grow distributable cash flow about 10% per year between 2019 and 2020, but it just shows you how out of favor it is," comments Simon Lack, the managing partner at SL Advisors, a management company that runs MLP-focused mutual funds and holds a position in SEMG.

Delek Logistics operates supply and marketing assets for oil, intermediate and refined products in Texas, Louisiana, Arkansas and Tennessee, primarily serving its parent, Delek U.S. Holdings, Inc. (DK, also New York-listed), an operator of refineries, convenience stores and logistics businesses. In the third quarter of 2017, DKL's distributable cash flow (DCF) did not quite cover the dividend payment. Owing to a 45% year-over-year increase in EBITDA and a 50% rise in distributable cash flow, DCF covered the dividend 1.25 times in the third quarter of 2018. As of Sept. 30, the net debt of Delek Logistics was 4.5 times trailing EBITDA.

Coal miners are another beneficiary of the energy-price shake-up. Coal-fired power plants struggled to compete with natural-gas-fired generation when gas traded in the low-$2 range. With a price above $4, coal generation is in the money. Utilities are burning inventory, driving coal stocks down by 26% year-over-year in August. This

Springtime for coal



sources: The Bloomberg, U.S. Energy Information Administration would be a key time for miners to increase production of the black mineral, yet, year-to-date through October, coal production actually declined by 8%. The protracted bear market in America's least favorite fossil fuel has proven no incentive to gear up new mining investment.

"Thus, demand exceeded purchases more than expected, forcing several utilities to search for additional tons just to finish the year," Indiana-based miner Hallador CEO Brent K. Bilsland said on the Nov. 6 earnings call (HNRG on the Nasdaq). "This has led customers, particularly in the southeast, to add Hallador as the new supplier. We began the year counting nine power plants as customers but have added an unprecedented six new customers this year, and we'll finish the year with at least 15 customers in total. These new customers are located in Indiana, North Carolina, South Carolina, Georgia and Alabama."

Hallador and Alliance Resource Partners L.P. (ARLP on the Nasdaq; see the issues dated May 18 and Sept. 8, 2017) are two of the few miners that are ready, willing and able to boost production. As for Hallador, it cautiously projects 2019 production of 7.3 million tons, flat with 2018, but says it could deliver as much as 9.5 million tons if the customers so demanded.

Despite growing production and a better supply/demand picture, each stock is cheap. Hallador trades at 6.6 times trailing earnings, 5 times enterprise value to EBITDA and is priced to yield 2.9%. Alliance trades at 8 times earnings, 4.3 times EBITDA and sports a 10.8% dividend yield. Hallador is more leveraged, with net debt footing to 2.5 times trailing EBITDA; Alliance's net debt is 0.7 times trailing EBITDA.

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