



HY E&P approaching a “normal” sector in the new normal oil market

In the first two years following the dramatic collapse in oil prices in 2H 14, E&P players were largely focused on structural changes to the business model which could fit into a restructured oil market. On the capital structure side, this included major efforts to repair the balance sheet via equity raise, conversion of debt to equity, some more distressed exchanges and debt reduction via asset sales. On the asset portfolio side, we saw many players implementing major overhauls – mainly a shift to the Permian by names like WPX, QEP and SM Energy. Others expanded their footprint in their core basins – not just established Permian players, but also companies in second tier basins like Bakken (Oasis) or Eagle Ford (Sanchez).

During this period, corporate strategies revolved around fundamental sector views (long term oil prices, preferred basins) and financial management by companies (equity raises, major divestitures). By early 2017, broad financial and portfolio strategies for most companies were largely in place. Post-OPEC deal in November 2016, the HY Energy sector was trading only 25 bps wide of the broader HY index, reminiscent of spreads seen during 1H 14, and a far cry from the >1,000 bps gap in early 2016. Meanwhile, the oil markets in 2017, while volatile, have answered some concerns regarding oil price downside risk by establishing the \$40 floor (for WTI). With the oil market settling at the “new normal” range, the exit of weak players from the market and major sector themes (like the Permian Premium) having played out, the HY E&P group has been transitioning to a “normal” HY sector with standard credit themes like operational performance, cash flow models, and balance sheets allowing for greater differentiation - in many ways similar to pre-2014 market, except for the keen new learned awareness of downside oil risk.

Solid operating performance of E&Ps continues into FY 17

On the operational front, E&P players responded to the low oil prices by delivering an impressive improvement in efficiencies during FY 15-16 - both in terms of cost reduction (capex and opex) as well as optimization of well productivity. In this effort, they were helped by the sharp deflation in service costs. Going into FY 17, most of the low-hanging fruit had already plucked and cost savings were slowing. Given this, efficiency gains in FY 17 have inevitably moderated but overall performance continues to be solid. As a measure of progress during the year, we analyze how well E&P names have delivered on their start-of-year production/growth targets with the Q3 17 updated guidance as measure of 2017 performance (see table below). The outperformance is quite evident for the oily peer group across the quality spectrum. Of the 16 oily names, 7 look set to deliver either (i) higher production (2-12% higher vs. original guidance) with capex unchanged or even lowered or (ii) similar production with sharply lower capex (eg: DNR capex budget taken down by 16%). BBG's guidance revision stands out – production target has been raised by 12% even as capex has been lowered by 4%. For another 4 names, both production and capex guidance have been revised (upwards, except for WLL) but we see the revised production-capex equation as more capital efficient. For example, WPX is currently targeting to grow oil production 12% above their start-of-year guidance with just a 9% increase in capex. For WLL, its production target is 4% below original guidance but the company has cut capex down sharply (by 14%) which we see as a net positive. Only for 4 names, the production-growth equation has been negative. Of these, OAS' case appears to be purely timing-related as exit rate production target has been maintained (FY 17E production target is down a modest 3%). That leaves us with just three names where there has been a genuine