



Value in Lower Quality oily and select Mid Quality names

After a year of major underperformance, we see relative value emerging in the Lower Quality Oily group – excluding BBG, all other names offer OAS of between ~800 to ~2,400 bps. This is driven by three factors. First, while downside risks to oil markets continue to be meaningful, they have arguably come in considerably over the last year (while spreads have widened sharply) as we move one year closer to potential market rebalancing. Second, we think market is underappreciating the fact most of these names can deliver a stable cash flow model (neutral FCF at maintenance mode) at or below low-\$50s oil. EP Energy is the only exception but even here, we see possible upside from sizeable value of its vast undeveloped acreage position – the solid valuation on a largely undeveloped portion of its Altamont asset (the least attractive asset in portfolio arguably) is an indication of this. Further, as noted above, many names have significantly improved capex efficiency during the year.

As discussed earlier, we like names like WPX and OAS which show superior growth-FCF equations compared to their peers. We acknowledge the top quality core assets of Higher Quality Oily names - but outside of Parsley these already trade inside the broader-BB index and it is therefore difficult to see much further upside.

Neutral on Higher Quality gassy names

Last year, we had expressed a preference for Higher Quality oily names versus their gassy counterparts given medium-term market dynamics in the global oil market were clearly more favorable than the US gas market. Specifically, we believed that the continued supply surge would limit upside above \$3 while weather-related demand could bring in significant downside volatility. As it turns out, the downside case is at the risk of playing out as we sit in mid-December entering 2018. Consequently, Higher Quality gassy names on average have underperformed the oily group by 60 bps.

While our view on the relative market outlook for the two commodities are unchanged, we now move to a neutral stance on the Higher Quality gassy names since at current trading levels (average of 319 bps), investors are being compensated for the higher risk. We also note that these companies have demonstrated that they can navigate through extended period of weak gas prices (FY 15-16 when gas prices averaged ~\$2.6/mcf) though admittedly it has put pressure on credit metrics. Any meaningful widening from current trading levels, as a reaction to further weakening of the 2018 market outlook, could therefore, provide an entry point to these names, especially considering pretty solid gas hedges – Antero, is of course, almost fully hedged but even other credits have a gas hedge ratio of between 54% to 70%.

Hedging status

The oily names in our peer group have hedged 44% of their FY 18E production. Around the same time last year, our oily peer group had an average hedge ratio of only 32% for FY 17. Looking specifically at liquids hedges which is more impactful for earnings, the peer average currently is 45% compared to 27% last year – understandable given the oil market turned positive only towards the latter part of FY 16. The average floor price for the group ranges from \$47 to \$53 (except for EPE ~\$60 floor). Given the buoyancy in oil prices since the Q3 17 company updates, we would expect the liquids hedge ratio to move substantially higher by the next earnings updates. The companies should also start building their FY 19 oil hedge program - average liquids hedge ratio is only 6% currently and nearly half the group is completely unhedged. The Mid Quality names lead the group with an average 2018 oil hedge ratio of 54% - outside of WLL, all others have covered >50% of their oil production. This makes sense considering all of them have expansive drilling