When Emotions are High Expect a Reversal

By Elliott H. Gue and Roger S. Conrad

Once again, fear has the energy sector in its talons. Benchmark WTI Cushing oil has yet to break its mid-June low. But the S&P 500 Energy Index has already dropped by nearly 9 percent this month alone. The Alerian MLP Infrastructure Index is down more than 11 percent. Worst hit of all have been mid-sized independent producers and the midstream companies and MLPs that serve them.

For example, Antero Midstream Corp (NYSE: AM) and Antero Resources (NYSE: AR) are off by 14.5 percent and 19 percent so far this month, respectively. Oasis Petroleum (NYSE: OAS) and Oasis Midstream Partners (NYSE: OMP) are lower by 49 percent and 22.6 percent, respectively.

That poor share price performance is in stark contrast to both corporate families’ solid second quarter numbers. And both Antero Resources and Oasis Petroleum largely affirmed previous production forecasts underlying their midstream affiliates’ expectations for volumes and therefore distributable cash flow and dividend growth.

Our Feature article takes a deep dive into results for each of our Actively Managed Portfolio recommendations. Notably, almost everything is down this month. But only one pick actually reduced guidance: EnLink Midstream LLC (NYSE: ENLC). And even that company covered distributions comfortably, while guiding toward better second half 2019 results.

Why the disconnect between the energy sector’s business and share price performance? Simply, investors are pricing in an expectation for much lower energy prices, especially for oil and natural gas liquids. The assumption is such a drop will force E&P companies to sharply curtail output, which in turn would reduce midstream companies’ cash flows available for distributions.

We see several holes in the argument. Shale producers have acquired cost discipline that many investors and participants still aren’t recognizing. That’s made them less susceptible to booms and busts than in the past. In fact, the generally solid second quarter results posted by best in class E&Ps already do reflect substantial declines in oil, NGLs and particularly natural gas prices from year ago levels.

Midstream companies have also greatly hardened their businesses against downturns the past several years. More than a few have disappeared. But for those left, building hefty payout coverage, cutting debt-to-EBITDA ratios and self-funding asset growth are the rule now.

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There are definitely still pockets of vulnerability in energy, many of which we identify in the Endangered Dividends List. And it’s understandable for investor emotions to run hot in a volatile and down trending market.

But our strong advice now is to read what we have to say in this issue and steel yourself to stick with our Portfolio picks. Even the hardest hit now are setting up for a massive re-rating higher, even if all oil prices can do is stay around $50 a barrel.

In This Issue

1 Feature: Q2 Earnings Part Two. We highlight more results and guidance of companies in our Portfolio and coverage universe.

2 Portfolios. We’re staying with the companies and MLPs in our Actively Managed Portfolio companies and High Yield List. Second quarter earnings confirm our thesis that this industry has hardened itself against a lower for longer energy price environment. We’re willing to hang in despite recent downside that’s largely the result of worries about the direction of oil and gas prices.

3 Endangered Dividends List. No dividend cuts this time around but a couple of companies on our list appear to be getting very close.

High Yield Energy Target List, Active Portfolio, Endangered Dividends List

The Actively Managed Portfolio holds our top recommendations in a $100,000 hypothetical model, including specific position sizes.

Our High Yield Energy List focuses on big distribution stocks that meet five criteria: (1) Yield of 7 percent or higher, (2) Strong and rising distribution coverage, (3) Consistent progress stabilizing and preferably reducing leverage, as measured by the debt-to-EBITDA ratio, (4) Manageable needs to raise new capital over the next 24 months, for CAPEX as well as refinancing existing debt, (5) Ownership structure that discourages changes in structure.

We’re disappointed with the investment returns earned to date by our High Yield Target list. This group’s underlying businesses, however, have largely stayed on track with the positive trends of the past few quarters.

Five of the original six companies we started out with in late May have now raised distributions. That now includes Enable Midstream LP (NYSE: ENBL), which announced its first payout boost since November 2015 to a new rate of 33.05 cents per quarter.

Enable has had the rising cash flow to resume regular dividend growth for some time. Management, however, has taken the conservative approach of building coverage and self-funding a big percentage of CAPEX to strengthen its balance sheet.

The strategy has paid off enough for Enable management to get comfortable resuming dividend growth. That’s particularly noteworthy, as it’s making this move into the teeth of investor selling of MLPs and midstream companies in general.
We’ve considered Enable a buy for some time, based on our conviction that its very low valuation in no way reflects the gathering strength of its underlying business. There was plenty in the second quarter results to justify our faith: 4 percent higher natural gas gathering volumes, 9 percent higher processed throughput, a near quadrupling of crude oil and condensate gathered volumes and 12 percent and 4 percent increases in interstate and intrastate transportation throughput, respectively.

Those gains weren’t just from the company’s core Anadarko Basin assets serving the SCOOP/STACK shale. They also reflect strong growth in the Williston Basin area of the Bakken as well as the Haynesville, where management says its system is “currently full.”

Enable also reported new and extended midstream contracts signed during the quarter for over 600,000 dekatherms per day of transportation capacity. And it’s won regulatory approval to extend pipeline contracts with a major customer, 53.75 percent owner and 50 percent general partner Centerpoint Energy (NYSE: CNP).

Centerpoint’s heavy ownership of Enable, and past indecision on what to do with it, arguably continues to restrain upside for the shares. Judging from the tenor of questions during the analyst call, at least some would have preferred a share buyback to a distribution increase. That’s despite the fact that actual float not owned by Centerpoint and 50 percent general partner OG&E Energy (NYSE: OGE) is only slightly more than 20 percent.

The company has some commodity price exposure through its NGL business, though it’s small and typically hedges 50 to 80 percent of it in advance. Management fielded calls about incentive distribution rights, though these are not currently a factor. And some analysts during the call expressed concern about rig counts in central Oklahoma going forward, though these remain robust where the partnership operates.

In any case, these concerns are more than reflected in Enable’s high yield of nearly 11 percent. That seems to be the opinion of insiders, who collectively have boosted their holdings by more than 65 percent according to Bloomberg Research. **Buy up to 17.**

Second quarter earnings and guidance calls for Antero Midstream Corp (NYSE: AM), Hess Midstream Partners (NYSE: HESM) and MPLX LP (NYSE: MPLX) are reviewed in the Alert we emailed to readers on August 1 Alert. It can be viewed now on the EIA website by clicking on the “Alerts” tab.

As with Enable so far, solid numbers and guidance have not yet supported this trio’s share prices. But sliding share prices do contrast greatly with operating performance. That’s also true for the other High Yield Energy List picks we highlight in the Feature article.

It’s always possible the macro picture will turn so negative that even these companies will falter. A drop to less than $40 oil, for example, would no doubt cause some shale producers to pull in their horns even more aggressively than they already have. And that may cause at least some of these companies to retrench further.

At this point, however, that doesn’t appear to be happening. And so long as it doesn’t, odds strongly favor a powerful comeback from all of these companies, even as they continue to increase what are already very high yields.
# High Yield Energy Target List

<table>
<thead>
<tr>
<th>Company (Exchange: Symbol)</th>
<th>Date</th>
<th>Recent Pr</th>
<th>Yield</th>
<th>12-Mo Dist Gr</th>
<th>Proj Dist Gr</th>
<th>Coverage</th>
<th>Debt/EBITDA</th>
<th>Total Return</th>
<th>Advice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Antero Midstream Corp (NYSE: AM)</td>
<td>5/22/19</td>
<td>7.81</td>
<td>15.73</td>
<td>146.0</td>
<td>5.0</td>
<td>1.00</td>
<td>3.2</td>
<td>-40.2</td>
<td>Buy&lt;14</td>
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<tr>
<td>Enable Midstream LP (NYSE: ENBL)</td>
<td>5/22/19</td>
<td>12.24</td>
<td>10.80</td>
<td>3.9</td>
<td>5.0</td>
<td>1.37</td>
<td>4.0</td>
<td>-10.5</td>
<td>Buy&lt;17</td>
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<tr>
<td>Energy Transfer LP (NYSE: ET)</td>
<td>5/22/19</td>
<td>13.33</td>
<td>9.13</td>
<td>0.0</td>
<td>5.0</td>
<td>2.00</td>
<td>3.6</td>
<td>-8.6</td>
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<tr>
<td>EnLink Midstream LLC (NYSE: ENLC)</td>
<td>5/22/19</td>
<td>7.41</td>
<td>14.37</td>
<td>6.0</td>
<td>5.0</td>
<td>1.20</td>
<td>4.0</td>
<td>-33.3</td>
<td>Buy&lt;10</td>
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<tr>
<td>Hess Midstream Part (NYSE: HESM)</td>
<td>5/22/19</td>
<td>18.18</td>
<td>8.73</td>
<td>15.0</td>
<td>15.0</td>
<td>1.02</td>
<td>0.5</td>
<td>-10.0</td>
<td>Buy&lt;24</td>
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<tr>
<td>MPLX LP (NYSE: MPLX)</td>
<td>5/22/19</td>
<td>27.12</td>
<td>9.85</td>
<td>6.4</td>
<td>6.0</td>
<td>1.36</td>
<td>3.9</td>
<td>-13.5</td>
<td>Buy&lt;37</td>
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<td>Oasis Midstream Part (NYSE: OMP)</td>
<td>6/6/19</td>
<td>17.02</td>
<td>11.53</td>
<td>19.7</td>
<td>20.0</td>
<td>1.70</td>
<td>2.8</td>
<td>-10.1</td>
<td>Buy&lt;20</td>
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<tr>
<td>Suburban Propane Part (NYSE: SPH)</td>
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<td>22.75</td>
<td>10.55</td>
<td>0.0</td>
<td>0.0</td>
<td>1.30</td>
<td>4.3</td>
<td>0.2</td>
<td>Buy&lt;24</td>
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</table>

Prices and yields as of August 7, 2019 close. Projected distribution growth is based on company guidance and Energy & Income Advisor analysis. Coverage is distributable cash flow divided by current distribution rate. All prices, returns and buy targets in US dollars. Source: Bloomberg, Energy & Income Advisor.
## Energy & Income Advisor: Actively Managed Portfolio

<table>
<thead>
<tr>
<th>Company (Exchange: Ticker)</th>
<th>Date Added</th>
<th>Position</th>
<th>Price</th>
<th>Indicated Yield</th>
<th>Total Return</th>
<th>Profit/ Loss</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Halliburton (NYSE: HAL)</td>
<td>12/04/17</td>
<td>200</td>
<td>$19.65</td>
<td>3.66</td>
<td>-53.57</td>
<td>-2,105.15</td>
<td>Sell 100 Shares</td>
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<tr>
<td>MPLX LP (NYSE: MPLX)</td>
<td>05/04/17</td>
<td>150</td>
<td>27.12</td>
<td>9.85</td>
<td>-4.05</td>
<td>-164.58</td>
<td>Buy&lt;37</td>
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<tr>
<td>Texas Instruments (NSDQ: TXN)</td>
<td>05/01/18</td>
<td>50</td>
<td>120.72</td>
<td>2.55</td>
<td>21.48</td>
<td>1,296.76</td>
<td>Buy&lt;112</td>
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<tr>
<td>Concho Resources (NYSE: CXO)</td>
<td>10/26/17</td>
<td>30</td>
<td>68.00</td>
<td>N/A</td>
<td>-47.62</td>
<td>-971.49</td>
<td>Buy&lt;165</td>
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<tr>
<td>Core Laboratories (NYSE: CLB)</td>
<td>06/30/18</td>
<td>35</td>
<td>41.15</td>
<td>5.35</td>
<td>-62.10</td>
<td>-894.36</td>
<td>Buy&lt;133</td>
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<tr>
<td>Enterprise Products Partners LP (NYSE: EPD)</td>
<td>01/09/17</td>
<td>150</td>
<td>28.38</td>
<td>6.20</td>
<td>21.89</td>
<td>931.72</td>
<td>Buy&lt;33</td>
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<td>Hess Midstream Partners LP (NYSE: HESM)</td>
<td>03/28/18</td>
<td>200</td>
<td>18.18</td>
<td>8.73</td>
<td>8.66</td>
<td>315.03</td>
<td>Buy&lt;24</td>
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<tr>
<td>Occidental Petroleum Corp (NYSE: OXY)</td>
<td>09/29/17</td>
<td>45</td>
<td>46.00</td>
<td>6.87</td>
<td>-22.19</td>
<td>-459.43</td>
<td>Buy&lt;75</td>
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<tr>
<td>Crestwood Equity Partners LP (NSDQ: CEOP)</td>
<td>11/06/17</td>
<td>120</td>
<td>33.56</td>
<td>7.15</td>
<td>56.93</td>
<td>2,292.88</td>
<td>Buy&lt;40</td>
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<td>Northland Power (TSX: NPI, OTC: NPIFF)</td>
<td>11/27/17</td>
<td>150</td>
<td>19.10</td>
<td>4.76</td>
<td>11.02</td>
<td>315.67</td>
<td>Buy&lt;20</td>
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<tr>
<td>WPX Energy (NYSE: WPX)</td>
<td>12/28/17</td>
<td>150</td>
<td>10.29</td>
<td>N/A</td>
<td>-27.54</td>
<td>-425.01</td>
<td>Buy&lt;19</td>
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<tr>
<td>Marathon Oil (NYSE: MRO)</td>
<td>06/01/18</td>
<td>320</td>
<td>12.05</td>
<td>1.66</td>
<td>-43.34</td>
<td>-1,671.37</td>
<td>Buy&lt;23</td>
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<tr>
<td>Plains GP Holdings (NYSE: PAGP)</td>
<td>06/14/18</td>
<td>328</td>
<td>22.42</td>
<td>6.42</td>
<td>-6.59</td>
<td>-484.37</td>
<td>Buy&lt;26.50</td>
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<tr>
<td>Antero Midstream GP (NYSE: AM)</td>
<td>12/28/18</td>
<td>70</td>
<td>7.81</td>
<td>15.73</td>
<td>-34.36</td>
<td>-187.86</td>
<td>Buy&lt;14</td>
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<td>Magellan Midstream Partners LP (NYSE: MMP)</td>
<td>01/02/18</td>
<td>30</td>
<td>64.22</td>
<td>6.31</td>
<td>0.42</td>
<td>8.00</td>
<td>Buy&lt;75</td>
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<tr>
<td>TechnipFMC (NYSE: FTI)</td>
<td>08/07/18</td>
<td>100</td>
<td>24.45</td>
<td>2.13</td>
<td>-20.06</td>
<td>-490.55</td>
<td>Buy&lt;33</td>
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<tr>
<td>Schlumberger (NYSE: SLB)</td>
<td>08/15/18</td>
<td>80</td>
<td>34.74</td>
<td>5.76</td>
<td>-41.69</td>
<td>-1,158.68</td>
<td>Buy 55 Shares&lt;42</td>
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<tr>
<td>Kinder Morgan (NYSE: KMI)</td>
<td>02/19/19</td>
<td>200</td>
<td>19.97</td>
<td>5.01</td>
<td>6.87</td>
<td>274.41</td>
<td>Buy&lt;22</td>
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<tr>
<td>Pembina Pipeline Corp (NYSE: PBA)</td>
<td>09/16/13</td>
<td>75</td>
<td>36.60</td>
<td>4.93</td>
<td>55.29</td>
<td>1,517.60</td>
<td>Buy&lt;35</td>
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<tr>
<td>TransCanada Corp (NYSE: TRP)</td>
<td>11/15/13</td>
<td>30</td>
<td>47.80</td>
<td>4.72</td>
<td>34.13</td>
<td>489.39</td>
<td>Buy&lt;50</td>
</tr>
<tr>
<td>Brookfield Renewable Energy Partners LP (NYSE: BEP)</td>
<td>09/16/13</td>
<td>40</td>
<td>35.43</td>
<td>5.81</td>
<td>90.68</td>
<td>1,285.11</td>
<td>Buy&lt;35</td>
</tr>
</tbody>
</table>

As of 08/07/19, close.  
Source: Bloomberg, Energy & Income Advisor
Endangered Dividends List

Endangered Dividends List companies are vulnerable for one or more of the following reasons:

- Cash flow coverage of distributions is inadequate.
- Elevated debt levels with imminent refinancing needs.
- Revenue pressure triggered by weakness for at least one key asset.
- Inability to access the equity market on favorable terms to fund capital spending, forcing management to utilize more internally generated cash flow.
- Exposure to volatility in commodity margins from either rising or falling prices of raw materials.
- Aggressive general partners anxious to buy in limited partners’ cash flows at discounted prices.
- Regulatory reversals.
- Expiring contracts with little hope for renewals at comparable rates.

There have been no dividend cuts in our Energy and Income Advisor coverage universe in the brief time since the previous issue went to post. Rather, the majority of EDL members have elected to maintain the same payout rates for at least another quarter.

One that still might is Navios Maritime Acquisition Corp (NYSE: NNA). The owner and operator of tanker vessels is currently expected to release its calendar second quarter on August 16, and to declare a quarterly distribution on August 12. Considering management held off on announcing first quarter results until late May, however, we may have to wait a bit longer for both.

The shares’ 20 percent current yield is a clear sign investors anticipate a cut. An elevated number of acquisitions this year has left the company with EUR315 million in maturing debt by the end of 2020, an amount equivalent to more than four times its current market capitalization.

The high yield has shut Navios out of the equity market. Meanwhile, the door to the debt market is also closed, at least on economic terms. The company’s 8.125 percent bonds maturing in November 2021 trade at a steep discount to par and yield more than 20 percent to maturity. Its primary loans are priced at ICE LIBOR plus 450 basis points.

Holding in the $16 million or so still paid out in common equity dividends alone won’t resolve Navios’ cash flow strain. But it will go a long way if the company can build on some of the positive trends from the first quarter, including the recent addition of newer ships and the 144 percent year-over-year lift in EBITDA. Navios is a hold on the expectation a dividend cut will further help right the ship.

Sanchez Midstream Partners (NYSE: SNMP) is expected to announce second quarter results mid-month and declare quarterly dividends about the same time. The shares’ 30 percent plus yield reflects an expectation the payout will likely be eliminated. As for debt capital, the company’s $210 million credit line was $172 million drawn at last count, and hardly cheap capital priced at 300 basis points plus the ICE LIBOR rate.
The big issue for this owner and operator of midstream assets is still what eventually happens to its general partner and most important customer Sanchez Energy Corp (OTC: SNEC). That oil and gas producer is currently attempting to negotiate forbearance with bondholders on a restructuring plan and continues to operate under a strategy of minimal capital outlays.

We expect a deal that takes a big bite out of the midstream company’s business and cash flow. The partnership is also directly exposed to slumping natural gas prices through some production assets. The big question is how much of a dividend cut is already reflected in Sanchez Midstream’s price. Until we know, this one is best avoided.

We added three Canadian energy producers to the EDL this summer: ARC Resources (TSX: ARX, OTC: AETUF), Peyto Exploration & Development (TSX: PEY, OTC: PEYUF) and Vermilion Energy (TSX: VET, NYSE: VET). Since then, all three stocks have retreated in the face of weakening North American natural gas prices.

A further fall for gas could eventually cause any or all of these stocks to cut payouts by early 2020. But the underlying businesses still appear quite capable of ultimately weathering this downturn and riding the next cycle higher, especially from their currently depressed share prices.

We discussed Vermilion’s generally solid first half 2019 numbers in the previous issue and our advice for aggressive investors to buy under 30 remains the same. ARC Resources posted an 8.7 percent lift in second quarter output from the year ago quarter, highlighted by a cut in operating expense per barrel of oil equivalent to $5.24 from $6.50. That’s a testament to management’s continuing push to develop its most economic resources by driving efficiency gains.

Even that wasn’t enough to offset the -11.5 percent drop in average realized selling prices for ARC’s output. And second quarter funds from operations per share slipped by -8.6 percent from year ago levels. FFO did cover the quarterly dividend by a 3.5-to-1 margin, with enough left over to cover a sizeable chunk of CAPEX and minimize the company’s need for new capital.

As a result, ARC’s CAD950 million credit line is wholly undrawn, leaving only CAD28 million in bond issues to refinance in 2020-21. Shares are likely to stay weak so long as Canadian natural gas prices do. But this company looks more and more like a survivor that’s close to bottoming out. Hold ARC.

Peyto won’t report its second quarter numbers until mid-month. But management has already declared the same 2 cents Canadian per share monthly dividend at least through September. That suggests results may be steadier than the recently falling share price suggests.

The company’s balance sheet situation is as solid as ARC’s, with the CAD1.3 billion credit line maturing 2022 completely undrawn. Beyond that, there’s a CAD50 million bond issue maturing in 2022 and another CAD100 million in 2025. The latter is currently priced with a yield to maturity of just 2.6 percent, hardly a level to expect were Peyto really in trouble. As with ARC, I expect even more gas-dependent Peyto to track Canadian gas price softness. The stock also looks like a survivor that’s close to a bottom but we’re going to rate it a hold for now.
### Endangered Dividends List

<table>
<thead>
<tr>
<th>Company (Exchange: Symbol)</th>
<th>Potential Cut</th>
<th>Risk Level</th>
<th>Last Increase</th>
<th>Rating</th>
<th>Declaration Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARC Resources (TSX: ARX, OTC: AETUF)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Aug-08</td>
<td>Hold</td>
<td>8/15/19</td>
</tr>
<tr>
<td>CrossAmerica Partners (NYSE: CAPL)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Nov-17</td>
<td>Sell</td>
<td>11/7/19</td>
</tr>
<tr>
<td>Cypress Energy Part (NYSE: CELP)</td>
<td>-100.0</td>
<td>Elevated</td>
<td>Nov-14</td>
<td>Sell</td>
<td>10/25/19</td>
</tr>
<tr>
<td>Equitrans Midstream Corp (NYSE: ETRN)</td>
<td>-33.0</td>
<td>Moderate</td>
<td>May-19</td>
<td>Sell</td>
<td>11/5/19</td>
</tr>
<tr>
<td>EGM Midstream Partners (NYSE: EGM)</td>
<td>-33.0</td>
<td>Moderate</td>
<td>Feb-19</td>
<td>Sell</td>
<td>10/22/19</td>
</tr>
<tr>
<td>Gaslog Partners LP (NYSE: GLOG)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Jan-19</td>
<td>Sell</td>
<td>10/24/19</td>
</tr>
<tr>
<td>Golar LNG Partners (NSDQ: GMLP)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>May-15</td>
<td>Sell</td>
<td>10/23/19</td>
</tr>
<tr>
<td>Green Plains Partners (NYSE: GPP)</td>
<td>-33.0</td>
<td>Moderate</td>
<td>May-18</td>
<td>Sell</td>
<td>10/18/19</td>
</tr>
<tr>
<td>Martin Midstream Part (NSDQ: MMLP)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Nov-14</td>
<td>Sell</td>
<td>10/22/19</td>
</tr>
<tr>
<td>Navios Maritime Acquisition (NYSE: NNA)</td>
<td>-33.3</td>
<td>Moderate</td>
<td>Nov-15</td>
<td>Hold</td>
<td>8/12/19</td>
</tr>
<tr>
<td>NGL Energy Partners (NYSE: NGL)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Nov-15</td>
<td>Sell</td>
<td>10/22/19</td>
</tr>
<tr>
<td>Peyto Expl &amp; Dev (TSX: PEY, OTC: PEYUF)</td>
<td>-25.0</td>
<td>Elevated</td>
<td>Dec-14</td>
<td>Hold</td>
<td>10/15/19</td>
</tr>
<tr>
<td>Sanchez Midstream Partners LP (NYSE: SNMP)</td>
<td>-100.0</td>
<td>Elevated</td>
<td>Nov-17</td>
<td>Sell</td>
<td>8/8/19</td>
</tr>
<tr>
<td>Sprague Resources LP (NYSE: SRLP)</td>
<td>-25.0</td>
<td>Elevated</td>
<td>May-18</td>
<td>Sell</td>
<td>10/24/19</td>
</tr>
<tr>
<td>Vermilion Energy (TSX: VET, NYSE: VET)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>May-18</td>
<td>Buy&lt;30</td>
<td>8/15/19</td>
</tr>
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</table>

Source: Energy and Income Advisor.

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**Q2 Earnings Part Two**

**Midstream: The Strong Get Stronger**

Chances are you’ve seen the disqualifier “past performance may not be predictive of future results.” But while that’s perfectly apropos for financial products and services, the opposite is increasingly true for midstream energy companies and MLPs.

For example, a company with a high distribution coverage ratio one quarter is much more likely to have a higher one the next than a company with narrow coverage. That’s because the high coverage company is by definition holding in more cash, and is therefore less dependent on capital markets to fund CAPEX to build further cash flow.

Similarly, midstream companies not pressured by maturing debt and high leverage ratios will have an easier time managing balance sheet issues. That also makes it easier to fund construction and acquisitions of new assets, which generate increased cash flow that makes handling debt burdens easier. Midstream companies operating in more actively drilled areas will have more opportunities going forward to invest. And larger, better-diversified companies also have an easier time of it when certain assets underperform.
No midstream company is as well diversified and capitalized as Actively Managed Portfolio member and long-time recommendation **Enterprise Products Partners** (NYSE: EPD). The MLP raised its distribution by another quarter of a cent for payment this month, keeping alive a string of quarterly increases dating back to November 2004.

The 2.3 percent annualized rate of growth remains subdued as management continues to focus on funding a high level of capital spending. Second quarter 2019 coverage was a record 1.8 times and free cash flow increased 37.6 percent, while distributable cash flow rose 21.3 percent on the back of 18.2 percent higher EBITDA.

During its conference call, management stated it remains focused on organic growth rather than making acquisitions. That's justified by a large backlog of CAPEX, including $3.2 billion in projects set to start producing earnings this year. The focus for the past several years has been US energy exports and Enterprise continues to have no problems finding opportunity, including a just announced Gulf of Mexico oil terminal.

Second quarter liquids volumes passing through the company’s system rose by 6.5 percent from a year ago. Marine terminal throughput rose 17.6 percent, natural gas pipelines 5.8 percent, NGL fractionation by 7.9% and fee-based natural gas processing 13 percent. **Still yielding north of 6 percent, Enterprise remains a buy up to 33 for even the most conservative investors.**

**Magellan Midstream Partners** (NYSE: MMP) boosted its quarterly dividend by 0.75 cents per unit above previous quarterly payout. Second quarter distributable cash flow increased by 18.1 percent. The company’s refined products operating margin surged by 17.1 percent, fueled by a 4.4 percent tariff increase on pipelines, partly offset by 1 percent lower short haul shipments on South Texas system. Crude oil transportation operating margin increased by 5.5 percent, while Marine storage margins rose 6 percent.

Looking ahead, Magellan has a distribution coverage target of 1.2 times, which it exceeded in the second quarter at 1.3 times. The company has also guided to 5 percent annual payout growth the next couple years. That’s a step down from the upper single digits of the past several years but is sustainable. **Now yielding north of 6 percent, the MLP’s value proposition is very strong in the mid-60s for even the most conservative.**

**Plains All-American Pipeline** (NYSE: PAA) and Actively Managed Portfolio member **Plains GP Holdings** (NYSE: PAGP) returned to dividend growth in May, with a 20 percent lift for both companies. The general partner’s ownership stake is essentially its only asset and source of revenue.

Plains’ second quarter results backed that growth as management raised 2019 guidance for both EBITDA and capital spending. Second quarter EBITDA increased by 55 percent, while distributable cash flow per unit surged 97 percent even after a 10 percent lift in shares outstanding to fund growth.

The key driver was 14 percent higher EBITDA at the Transportation segment, which continues to benefit from Plains’ strategic refocus of recent years on the Permian Basin. The company announced this week that it’s beginning service on the Cactus Pipeline in Texas, which should provide a big lift to second half cash flow. Facilities results were flat while the downsized Supply and Logistics unit benefitted from higher crude oil differentials in the Permian Basin and Canada.

Plains’ second quarter distribution coverage of 2.02 times compares to 1.23 times in the year ago quarter, resulting in $266 million in “excess” cash. On an annualized basis, covers roughly two-thirds of projected $1.5 billion 2019 growth CAPEX. And while there’s $1 billion in maturing debt through the end of 2020, the nearly $3 billion in credit lines are wholly untapped. Cost of debt capital is very low with Plains bonds due February 2045 yielding just 4.77 percent to maturity.
All this suggests both MLP and parent are sharply undervalued, with another big distribution increase on the way next year as robust capital spending brings on more revenue streams. **Plains All-American is a buy up to 25. Actively Managed Portfolio pick Plains GP is a buy up to 26.50.**

**Energy Transfer LP** (NYSE: ET) posted a 25 percent boost in second quarter EBITDA and 23 percent better distributable cash flow than a year ago. That performance took its distribution coverage ratio up to 2 times, with $800 million generated during the quarter. Annualized, that’s nearly 70 percent self-funding of projected 2019 CAPEX of $4.6 to $4.8 billion.

Management also raised its 2019 EBITDA guidance range to $10.8 to $11 billion. And the partnership pushed its debt to EBITDA ratio down to just 3.61 times, with $3.56 billion of a $6 billion credit facility now available for drawing.

The results reflect savings from the simplification merger of the former Energy Transfer Partners and its general partner Energy Transfer Equity, which closed last October. The bigger driver of growth, however, was continued successful asset expansion in Texas and the upper Midwest, including the ongoing Permian Express 4 expansion to bring another 120,000 barrels a day oil transport capacity on stream to the Gulf Coast.

Intrastate transportation and storage was a star division, with EBITDA raised 39.4 percent from a year ago. Interstate T&S was higher by 22.7 percent, NGLs and Refined Products by 39.7 percent, Crude Oil Transportation 37 percent and investments in **Sunoco LP** (NYSE: SUN) and **USAC Compression LP** (NYSE: USAC) 9.4 percent. That was partly offset by a -3 percent dip at Midstream and Other Services.

The upshot was another solid quarter in Energy Transfer’s turnaround with high return assets coming on stream, low return operations dropping off and debt and costs reduced. With $3.062 billion of debt still coming due by the end of 2020, management may continue to hold in cash rather than return to regular dividend growth immediately. **But the 9 percent plus yield appears secure the shares are still a buy up to 17.**

**Crestwood Equity Partners** (NYSE: CEQP) lifted its second quarter EBITDA by 18 percent, fueling 19 percent higher distributable cash flow. That pushed the second quarter distribution coverage ratio out to 1.5 times. The company also stayed on track to reduce its current 4.2 debt to EBITDA ratio down to a range of 3.5 to 4 times by the end of the year.

The company appears to be feeling the pinch from declining producer activity in the Marcellus Shale of Appalachia, where second quarter system volumes dropped -23.3 percent from a year ago. It also saw reduced throughput in the Barnett Shale (-10.8 percent) as others have. That’s offset by growth at the Bakken Arrow property (up 16.5 percent), Delaware in the Permian (6.3 percent) and the Powder River Basin (55.6 percent).

Overall gas gathering volumes declined by -5.8 percent and compression volumes fell -22.1 percent. But processing throughput rose by 7.4 percent, Bakken crude oil increased 16.7 percent and Bakken water was up 46.6 percent. Storage and Transportation both saw capacity declines in the Northeast region. But Gulf Coast Storage rose and the COLT Hub saw a lift in rail loading (37.9 percent), offsetting a small decline in outbound pipelines volumes. Marketing, Supply and Logistics were more profitable though volumes were lower.

That’s a lot of moving parts over multiple basins for Crestwood to manage. But according to management, second quarter shortfalls were due to timing, rather than the start of a prolonged slowdown in customers’ activity, even as Bakken and Power River activity pick up steam. The water business too looks poised for rapid growth, with end-year volumes expected upwards of 100,000 barrels a day versus 64,000 now.
There’s still the question of having Chesapeake Energy (NYSE: CHK) as a large customer, as that company continues to face a severe challenge from weak natural gas prices. Fortunately, that relationship is no longer as important as it was in the past, particularly with Crestwood as of July 1 now receiving 50 percent of cash flow from its Stagecoach venture with Consolidated Edison (NYSE: ED).

During the earnings call, management stated the partnership in on track to meet its de-leveraging goals “in the early part of 2020.” That will occur as major capital projects in the Bakken and Powder River Basin start driving growth and take distribution coverage “close” to 2 times for full year 2020. CFO Robert Halpin stated that’s when “some amount of incremental distribution growth clearly makes sense,” his preference being reliable incremental quarterly boosts.

That’s certainly good by us, though some analysts indicated preference for share buybacks on the call. Buy Crestwood while shares still trade under our buy target of 40.

EnLink Midstream LLC’s (NYSE: ENLC) distribution was again well covered 1.2 times by distributable cash flow, with debt to EBITDA a modest 3.97 times. Investors, however, seemed more interested in a $40.5 million after tax loss to reflect the bankruptcy filing of customer White Star Petroleum Holdings.

Management also forecast “moderating” activity for its Oklahoma assets and “a shift in timing of producer activity in the Permian Basin.” The result was a reduction in 2019 EBITDA guidance to $1.07 to $1.1 billion, and expected distributable cash flow to a range of $715 to $735 million.

That’s a big step down from the previous guidance range of $730 to $810 million. But EnLink also announced an increase in the mid-point of projected growth capital expenditures from $645 million to $670 million, related to a new contract expected to start producing cash flows in 2021.

Management is still guiding to a long-term coverage ratio of 1.2 to 1.3 times, with “up to 5 percent” annual dividend growth. And there’s no real balance sheet pressure, with the only debt maturity before 2024 an $850 million term loan due December 2021. There’s also $1.585 billion undrawn and just $160 million used on the credit line maturing in 2024. And the company’s June 2047 bonds yield just 6.41 percent to maturity, meaning cost of debt capital is reasonably low.

When a company reduces guidance, there’s always the risk it will have to so it again. We believe management will be able to resist such a move.

For one thing, EnLink enjoyed strong second quarter growth in volumes across its operations. The Oklahoma segment is forecast to grow profit by 5 to 10 percent in the second half of the year due to higher throughput. Permian segment profit growth, meanwhile, is anticipated at 15 to 25 percent, reversing a second quarter decline from crude oil price fluctuations. Management expects to recapture the impact in the second half of the year, as well as a rebound in Louisiana as expansion offsets contract expirations.

Operating profit in the Barnett shale of North Texas dropped by 21 percent. The primary reason is former general partner Devon Energy (NYSE: DVN) continues to pull back from the area as contracts with EnLink expire. Management also noted during the conference call that competition in the Permian Basin for new business has grown as drilling activity slows.

We think the company is better able to handle both challenges due to much streamlining of operations the past several years. The company also has arguably a better sponsor in privately held Global Infrastructure Partners than it previously had in Devon Energy. And the ascension of executive chairman Barry Davis as the new CEO is a positive as well.

With numbers still supporting the now 14 percent plus dividend, the result is a still strong value proposition,
provided management can deliver on guidance. With investor sentiment this low for midstream energy, it’s difficult to see EnLink shares rebounding quickly and we’re disappointed in the recent decline. But from this price, we’re going to keep them in the Portfolio. **Those yet to get in can buy at 10 or lower.**

**Canadian Edge**

Our Actively Managed Portfolio currently features four Canadian names: **Brookfield Renewable Energy Partners** (TSX: BEP-U, NYSE: BEP), **Northland Power** (TSX: NPI, OTC: NPIFF), **Pembina Pipeline Corp** (TSX: PPL, NYSE: PBA) and **TC Energy Corp** (TSX: TRP, NYSE: TRP). The first two are contract power producers, the latter midstream companies.

As we noted in the July 21 issue of EIA “Finding Value in Canada,” it hasn’t been easy to thrive in the Canadian energy market the past several years. These companies have done so with a combination of prudent expansion and conservative financial strategies. That’s precisely what they demonstrated in second quarter results. Northland is expected to report results later this month.

Brookfield’s share of generation at operated facilities increased by 17.8 percent over the year ago quarter, fueling a 34.5 percent lift in funds from operations per share. The primary driver was expanded portfolio investment, with the latest the acquisition of a 210-megawatt capacity wind portfolio in India. The company also benefitted from the continuing turnaround at its **TerraForm Power** (NSDQ: TERP) affiliate, its growing investment in the Alberta power portfolio of **TransAlta Corp** (TSX: TA, NYSE: TAC), better wind and water conditions in many of its service areas, higher pricing at its Colombia unit and successful expansion of its global rooftop solar portfolio.

Looking ahead, Brookfield plans more facilities utilizing energy storage to optimize performance. And it continues to successfully fund growth with a variety of means, including asset sales such as its South African projects. The balance sheet is rates BBB+ and the first half payout ratio is 75 percent.

*Brookfield trades slightly above our buy target of 35.* But it remains a very strong value proposition there for conservative investors, with a yield just shy of 6 percent and a target annual dividend growth rate of 5 to 8 percent. The company pays dividends in US dollars.

Pembina Pipeline Corp enjoyed a 9.3 percent bump in its second quarter EBITDA, despite generally flat system throughput volumes. That demonstration of efficiency bodes very well for the second half of 2019, when several new large assets will enter service virtually fully contracted.

At a time when capital of any kind is in short supply to the energy sector, Pembina continues to largely self-fund its growth, with dividends plus all CAPEX just 1.11 times cash flow from second quarter operating activities. We should see a resumption of free cash flow after dividends as the new assets come on stream, despite a 69.4 percent lift in CAPEX from a year ago.

Pembina’s current yield and annual dividend growth rate of 5 percent plus make for a solid value proposition. And with a market capitalization of $18.6 billion, it’s hard not to see the company as ultimately a takeover target for the giants in its industry. **Buy up to 38.**

Formerly TransCanada, TC Energy Corp posted a 16.3 percent lift in its second quarter “comparable earnings,” which exclude the impact of divestitures, acquisitions, mark-to-market adjustments and other non-recurring factors. Funds from operations surged 14 percent on strong legacy asset performance and as the company brought CAD5.6 billion (approximately $4.2 billion) of new assets into service in the first half of 2019.
Looking ahead, the company has CAD32 billion in "secured projects underway" to enter service by 2023, with CAD7 billion coming on stream by end-year. That excludes the Keystone XL pipeline, which continues to slog ahead with the company overturning a court order blocking a permit last week.

Management recently affirmed its guidance for 8 to 10 percent annual dividend growth through 2021 based on new development. It will fund CAPEX with a combination of internally generated cash flow and sales of non-core assets, with CAD6.3 billion of transactions currently in progress. Other major projects that promise to move the profit meter include a life extension program for the Bruce Power nuclear plant in Ontario and the Coastal GasLink pipeline, which last month won approval from the Canada’s National Energy Board.

TC shares failed to lift off following strong second quarter results for a couple of reasons. One was weakness in the Canadian dollar versus the US dollar, which has a negative impact on the company’s US dollar share price as well as the value of its quarterly dividend for US investors. The other is concern about ongoing negotiations with the Mexican government over pipeline rates.

We continue to expect the Canadian dollar to be more of a positive than a negative for US investors in Canadian stocks going forward. As for the negotiations in Mexico, TC management has warned that a final resolution may take until 2021 should current arbitration proceedings break down.

Ultimately, however, it’s in both parties’ interest to have an investment environment where much needed infrastructure gets built. And in any case, the company has plenty of projects elsewhere to pick up the slack in a worst case for Mexico. Yielding nearly 5 percent and growing its payout at a near double digit rate, TC Energy is a buy up to 50 for even the most conservative investors.

E&Ps: Discipline and Free Cash Flow

It’s been a tough quarter to be in the oil and gas exploration and production (E&P) business.

Of course, it doesn’t help that West Texas Intermediate (WTI) crude oil prices have fallen more than 15% since the mid-July highs, straight through the heart of Q2 2019 earnings reporting season. However, it’s clear that the sector is so completely out-of-favor that even good news is bad news – even E&Ps that beat estimates, raised production estimates and cut their capital spending plans saw little or no real upside.

Meanwhile, E&Ps that missed estimates, even by a small margin or due to transitory issues that might be ignored in a normal market were hit hard.

Our view is that the investment case for the E&Ps revolves around the coming turn in free cash flow (FCF).

As we’ve noted on countless occasions in this publication, Wall Street has traditionally rewarded E&Ps for production growth even if that growth came at the cost of outspending cash flow and taking on debt or issuing stock to fund the difference. Over the past few years, however, there’s been a shift in sentiment – investors are now looking for the E&Ps to generate real returns on their drilling activity by spending within cash flow and generating real free cash flow even at moderate “mid-cycle” oil prices around $50 to $55/bbl.
The good news is that many E&Ps are already generating meaningful free cash flow and several are in the midst of a turn in 2019-20, from significant cash outspend to free cash flow generation.

Let’s look at this situation in a slightly different way.

In many ways, US E&Ps are becoming industrial or manufacturing companies. After all, producing oil from shale is essentially a manufacturing process – the resource is widely distributed and producing oil is mainly a matter of optimizing well design to maximize output relative to costs.

Like the industrials, energy is also a cyclical business with leverage to the health of the US and global economies.

And, well run industrial companies can throw off significant free cash flow – industrials like Honeywell (NYSE: HON), Ingersoll-Rand (NYSE: IR) and Dover (NYSE: DOV) currently generate free cash flow yields of between 4% and 5% right now (free cash flow divided by market cap).

Should E&Ps follow-through on their current CAPEX plans and successfully generate durable free cash flow over the next 18 months, even with oil prices stuck in the $50/bbl region it stands to reason the group would trade at similar valuations to the industrials.

Indeed, for many years that was essentially true:

Looking back over the past decade, the three industrials on my chart – Dover, Honeywell and Ingersoll-Rand – and the two shale producers on my chart – Concho Resources and Occidental Petroleum (NYSE: OXY) – traded at similar Price/CF multiples. And multiples for both groups generally rose from 2013-14 until 2017.

However, over the past two years, valuations for these two groups have notable diverged – the 3 industrials
on my chart now trade for between 13.7 and 17 times cash flow, close to 4 times the multiples of the two E&Ps on my chart.

Ultimately, we believe closing this valuation gap – at least to some extent – is a function of execution and discipline. The E&Ps have a reputation for throwing discipline out the window and chasing growth by boosting CAPEX in strong commodity price environments. Like Pavlov’s dogs, investors are conditioned not to believe E&P management teams’ claims of rising free cash flow and future returns from new shale wells.

However, this year we’re finally seeing concrete signs of a change – for instance, even as oil prices rose sharply in the first half of 2019, the US oil-directed rig count continued to fall. And, in the second quarter calls we listened to, most producers are planning a further slowdown in drilling activity and spending for the second half regardless of the future path of oil prices.

Should the E&Ps newfound discipline translate into meaningful free cash flow and the resulting dividends, debt reduction and share buybacks – into 2020, we believe the group could see a serious valuation re-rating, closing gap with the industrials.

Of course, getting to that point is likely to require some patience as this quarter’s dismal stock performance in reaction to solid earnings calls shows. However, we believe the inflection point in free cash flow will be a powerful upside catalyst.

Let’s review Q2 2019 earnings from 3 more E&Ps in the Actively Managed Portfolio that have reported to date:

≫ **Concho Resources (NYSE: CXO)**

Concho Resources reported disappointing Q2 2019 results; however, the 32% decline in the stock since the end of July, representing a $6.2 billion loss of market value, is out of all proportion to the Q2 miss.

Let's review the evolution of Concho’s 2019-20 strategic plan and guidance over the past year.

Back in November 2018, as CXO reported its Q3 2018 earnings, management announced a plan to spend $3.4 to $3.6 billion in 2019, generating 35% to 40% growth in crude oil production and 25% to 30% growth in total output (on a barrels of oil equivalent basis). For comparison, CAPEX last year was $2.72 billion.

In February, at the company’s Q4 and full year 2018 call, management cut their capital spending guidance by around $600 million to a range of $2.8 to $3.0 billion and guided for flat CAPEX on a year-over-year basis in 2020. Management cited the volatility in oil prices and a desire to set its CAPEX plans based on a $50/bbl WTI oil price environment as a rationale for cutting its CAPEX back in February.

However, here’s what’s really important. Despite a roughly 17% cut in CAPEX guidance earlier this year, CXO was still looking for overall production growth of 21% to 25% in 2019 and for oil output to jump 26% to 30% annualized this year.

In short, with less spending and still impressive oil output growth, CXO becomes a free cash flow machine. Management guided for positive free cash flow in 2019 inclusive of the dividend (approximately $100 million annualized) with oil around $50. In 2020, management noted that it could generate $1 billion in cash flow at $60/bbl WTI and positive FCF even after paying its dividend at an even lower oil price than in 2019.

Finally, just one quarter ago in early May management reiterated its CAPEX guidance but raised its total production growth guidance for 2019 to 23% to 27% annualized with oil output up 27% to 31% annualized.
And that brings me to the recent Q2 2019 earnings call.

The big issue CXO faced in Q2 was poor results from its Dominator project in the Delaware Basin (western part of the Permian). Dominator involved drilling 23 wells with an average lateral length of 4,400 feet. The spacing – distance between wells on this section of land – was about 50% tighter than prior developments in this region. Drilling proceeded according to plan and initial production rates were solid; however, performance of the wells over time indicates that CXO drilled the wells in the prolific Upper Wolfcamp interval too close together.

This is a clear example of the parent-child interference problem we highlighted in the most recent issue of *Energy & Income Advisor* “Services: International Growth, Shale Changes.” This happens when production from one well causes a reduction in production from neighboring wells. It’s a balancing act for producers because if they space wells too far apart overall recoveries of the oil in place drops (literally leaving money in the ground) while if wells are spaced too tightly, the parent-child well interference problem can result in falling well output.

In CXO’s case, the problem is the Dominator wells were expected to be oil-rich wells. In other words, CXO’s total output (in barrels of oil equivalent volume terms – is about 63% to 64% crude oil and these wells were expected to generate a larger amount of oil in percentage terms (some of CXO’s new wells in the Delaware Basin are generating 70%+ crude oil cuts).

Given the parent-child issues uncovered at Dominator, CXO is altering its development plans to space wells further apart and that means fewer oil rich wells will be drilled in the second half. Management was forced to lower its guidance for 2019 crude oil production growth to a range of 22% to 26% annualized. Note that’s below the lower end of its prior guidance for 27% to 31% growth in oil output for this year.

Clearly this is not good news.

However, what’s really important is that in years past the company might have simply increased its CAPEX to drill more wells and make up for the slower oil production growth outlook. This time around, however, management is sticking to its discipline for the remainder of 2019 and cutting CAPEX to remain within the $2.8 to $3.0 million revised drilling budget outlined back in February.

CXO’s 2019 drilling budget was always expected to be front-end loaded – the company spent $926 million in Q1 and $785 million in Q2 for a total of $1.711 billion, leaving roughly $1.1 to $1.3 billion ($550 to $650 million per quarter) remaining in the budget for the second half of the year. However, the activity reduction already appears to be ahead of schedule – management noted that it had 33 rigs running in Q1 2019 and 26 rigs running on average in Q2 2019. Moreover, as of the time of its call on August 1st, it was only running 18 rigs.

And despite the falling rig count and the disappointing Dominator wells, management’s guidance still sees significant oil production growth in 2019.

Let's put this into context.

In 2018, CXO reported total production of 263,000 boe/day and 168,320 bbl/day of that was oil (64% of the total). Using the midpoint of management’s (upwardly) revised guidance issued back in early May, total production this year was expected to be about 328,750 boe/day and total oil production would come in at 217,133 bbl/day (66% oil).

Using the midpoint of CXO’s revised guidance range (issued at the beginning of August), the company's total output this year is expected to come in at the same 328,750; however, oil output is expected to be
Just 208,717 bbl/day, flat with 2018 at 63% to 64% of total output.

That’s a downward guidance revision of less than 8,500 bbl/day, which at a price of $55/bbl for WTI over an entire year represents oil-related revenues down $168 million compared to prior expectations. That’s $168 million compared to CXO’s trailing 12-month revenues of more than $4.4 billion (a little under 4%).

Again, that’s obviously not good news but based on these fundamentals alone it’s hard to justify shaving off nearly a third of the company’s market capitalization ($6.2 billion in lost value).

Moreover, management largely reaffirmed its outlook for free cash flow in the 2019-20 period saying:

*When we first described the cadence over the next two years, we described 2020 as production numbers that translated into double-digit production growth with oil production outpacing the overall growth, where we saw a free cash flow at $50 oil and where we saw free cash flow approaching $1 billion at $60 oil, and that’s still what we see today under that same base budget scenario.*

*Source: Concho Resources Q2 2019 Earnings Results and Conference Call August 1, 2019*

In other words, with oil around $60/bbl, management believes CXO is on track to deliver $1 billion in free cash flow for 2020 after paying its $100 million annualized dividend. Should it meet that target, the company would generate a free cash flow yield of 7.5% next year based on the current price, which would put it in the top 25% or better of all companies in the S&P 500.

And, keep in mind that CXO has hedged more than 40 million barrels of its 2020 output at a price of $57.27/bbl. That’s an amount equivalent to more than half of its expected 2019 oil output – that adds an additional layer of protection to the company’s 2020 free cash flow inflection story.

Moreover, it’s worth remembering that the disappointing Dominator spacing test was a test, NOT a sign that the company’s acreage is of poor quality or that its wells are underperforming across the board. As management noted in response to another analyst question:

*Yeah. Thanks, Paul. This year was a transition year for us and we entered the year harder on capital and also harder on production. And so when oil prices came down from where they were late last year, we reduced our capital budget and our capital budget range. We think it’s very important to do what we said we are going to do and land the capital budget inside that range. And we are continuing to drive that number down. So -- and demonstrate our ability to show capital discipline and live within cash flow. So that's -- that is a driver for us for 2019.*

*And we -- on almost every project we do, we have some level of experimentation, and so we have to fit that experimentation within the projects and the capital that we are deploying. So -- and as we'll describe, '19 was heavily weighted towards density testing. And as we've described in the past, you can't test all the variables at one time. You can't test sand loading, completion design and density all at the same time and know what you got. So that's one of the answers. We feel very confident that landing '19 where we said we are going to land it and then setting us up for the 2020 and beyond as the way we described it in the past as a more modest capital deployment on our properties, double-digit growth, and increasing amounts of free cash flow.*

*Source: Concho Resources Q2 2019 Earnings Results and Conference Call August 1, 2019*

As CXO moves into “development” mode on its acreage, it’s testing multiple variables to establish a standard well design including the optimal amount of sand proppant to load into its wells, the optimal well lateral length and, as Dominator did, well spacing/density. Not every test or experiment is going to prove
successful – and Dominator represented the densest wells the company has drilled by far – however this type of experimentation is necessary as CXO moves into manufacturing mode.

Lastly, CXO was asked about its gas-oil ratio. In other words, the company isn’t cutting total production guidance for 2019 but it is cutting oil production guidance, which means that the ratio of lower value gas and natural gas liquids to oil production is remaining around 63% to 64% rather than rising as CXO has originally envisioned.

However, management seemed to indicate this is a transitory issue rather than the beginning of a trend – management continues to guide towards a gas-to-oil ratio in the “mid 60s” percent range.

So, all this begs the question:

**Why did CXO lose nearly one-third of its value following August 1st results?**

We see the answer as four-fold:

1. **The sector is deeply out of favor.** That means companies with strong results are seeing only modest rewards and those reporting weaker than expected results are seeing extreme downside reactions. As we’ll explain in a moment, both WPX Energy (NYSE: WPX) and Occidental Petroleum (NYSE: OXY) reported strong results but only saw modest bounces based on the news from depressed levels. Pioneer Drilling (NYSE: PXD) even reported Q2 production at the top end of guidance, increased guidance for total 2019 oil output CUT its CAPEX budget by $150 million for 2019 AND increased its annualized dividend from $0.64 per share to $1.76 per share; yet the stock continues to trade near the lowest levels since the 2015-16 lows.

2. **The market remains worried about the macro picture.** Based on the consensus outlook for free cash flow, the energy sector looks cheap and, for the most part, these estimates are based on WTI oil prices in the $50 to $55 range. If oil prices were to average around $40 to $45/bbl next year instead, that would impair the free cash flow inflection story and the sector suddenly looks fairly valued (or even expensive).

3. **It’s a show-me story.** As we’ve written before, the sector has developed a reputation for poor capital discipline and an inability to generate free cash flow. In our view, there are already concrete signs that’s changing such as CXO’s decision to maintain its CAPEX plan despite a deteriorating production growth outlook. However, we believe the market wants to see actual free cash flow in hand -- likely deployed through dividends, debt repayment and share buybacks – before there’s a comfort level with this free cash flow story.

4. **Well productivity problems.** Two years ago in early August 2017, shares in Pioneer Natural Resources (NYSE: PXD), a Permian producer just like CXO, were hit hard when it reported a higher than expected gas-oil ratio on some of its new wells.

Specific to Concho, we believe there was some disappointment that the company did not actually guide down CAPEX for 2019 to reflect ongoing oil price volatility and planned downscaled activity. The company will be building its inventory of drilled uncompleted wells (DUCs) to give it good production momentum into 2020; however, the market probably would have preferred lower CAPEX.

In short, CXO’s current valuation is tough to justify. If it even comes close to meeting its FCF targets for 2019-20 we see the stock trading significantly higher. In the short-run, the stock will continue to follow sentiment on oil prices but we believe that in 2019-20, the free cash flow story for CXO and other exploration and production (E&Ps) stocks will result in a dramatic re-rating.

Despite the current post-earnings drop, we rate CXO at current prices in our Actively Managed Portfolio.
Occidental Petroleum (NYSE: OXY)

Occidental reported strong Q2 2019 operating results though much of investors’ focus during the conference call is on the shareholder vote and subsequent closing of the Anadarko (NYSE: APC) acquisition scheduled for August 8th.

On the operational front, the company continued with strong execution in the Permian with production coming in about 11,000 boe/day above the midpoint of its prior guidance. Management also noted that, based on industry data, the company has drilled 26 of the top 100 performing wells in the Permian on a 6-month cumulative production basis even though it has only drilled around 7% of total wells in the region.

The investment case for OXY rests on the company’s ability to generate free cash flow and grow its dividend -- representing a whopping 7% yield at current prices -- even at relatively modest assumptions for oil prices. Adding an additional layer of complexity is, of course, the Anadarko deal and how execution on such a large-scale transaction impacts their cash flow generation potential.

The company has made further progress on proving the merits of the deal, reducing the risks of the acquisition and shoring up confidence in their ability to grow the dividend after the OCY/APC deal closes.

First, on the company’s August 1st conference call, OXY announced it had hedged 300,000 bbl/day of its 2020 oil output using a three-way collar strategy.

Simply put, the company essentially sold Brent oil call options at a strike price of $74.09/bbl and sold Brent put options at a strike of $45/bbl. Then, using the proceeds from these sales, OXY purchased Brent puts with a strike of $55/bbl.

At the time of this writing, Brent trades at roughly $56/bbl, down from highs over $75/bbl at the end of April. The 52-week low was around $50/bbl at the end of 2018.

Using this three-way collar strategy, OXY is essentially protecting itself against a decline in Brent oil prices below $55 while “selling” upside for Brent above $74.09 and additional downside potential for the hedge below $45/bbl. Since OXY is funding the purchase of the puts with sales of calls and puts on Brent, the transaction is a costless way to hedge roughly 40% of the combined OXY/APC projected oil output for 2020.

It’s worth noting that OXY doesn’t traditionally do much hedging except when it makes an acquisition — in this case, management is hedging 2020 output to provide yet another level of uncertainty around free cash flow next year as it seeks to reduce leverage (debt) it’s taking on to fund the transaction.

In addition, OXY has announced a joint venture with Columbia-based Ecopetrol (NYSE: EC) covering 97,000 net acres in the Midland Basin.

Most of OXY’s Permian development is in the Delaware Basin (the western part of the play) rather than the Midland. So, the company has had limited production and minimal activity in this region.

Under the terms of the JV, Ecopetrol will give OXY an immediate cash payment of $750 million and $750 million in carried capital in exchange for a 49% interest in the JV. That means OXY retains a majority stake (51%) and will continue as operator of the field while Ecopetrol funds 75% of OXY’s CAPEX near term. And the deal does NOT cover any existing production from this 97,000 net acre tract, which will remain OXY’s.

In effect, this JV gives OXY an immediate up-front cash payment and allows the company to accelerate development of oil-rich Permian acreage where it previously had minimal activity.

If we add the previously announced sale of Anadarko’s African assets and LNG project in Mozambique for
$8.8 billion to the Midland JV, OXY has already raised $9.5+ billion since announcing the APC deal out of management’s target of $10 to $15 billion in total divestitures.

This week, the company sought to raise $13 billion through a 10-part bond issue. To say the issue was well-received is an understatement – at the peak, OXY received $75 billion worth of orders for this $13 billion deal. The company was able to cut the pricing – the yield it pays investors to borrow money – by between 35 and 50 basis points (0.35% to 0.50%) because investor interest in the issue was so high.

All told, OXY announced a combined capital spending budget for OXY/APC of $6.6 billion annualized (likely starting next year) compared to a combined total of roughly $9.0 billion today. Originally, management had proposed a CAPEX reduction of $1.5 billion annualized as one of the merits for the combination – as a combined company they can generate savings on capital spending and still produce oil output growth. This new, lower CAPEX budget of $6.6 billion appears to factor in larger saving on the CAPEX side of the equation.

Occidental believes it can cover its dividend and be cash flow breakeven at $40/bbl WTI prices and that it would see flat production with prices at that depressed level. That’s because at prices under $50/bbl, the company would cut its CAPEX budget to preserve cash flow.

At around $50/bbl WTI OXY/APC would spend the CAPEX of $6.6 billion, generating production growth of about 5% and still generate excess free cash flow. Further, management noted that for every $1/bbl increase in WTI above $50/bbl, the incremental cash flow would be around $255 million per year. That implies some $3.5 billion in free cash flow AFTER the dividend is paid at $60/bbl oil prices.

Take a look at this chart:
Even under conservative assumptions for oil prices over the next few years, OXY is in a position to generate enough cash flow to pay its current quarterly dividend of $0.79 per share and significantly pay down the debt it’s taking on to fund the APC acquisition.

OXY has a long-term track record for paying – and growing – its dividends over time. Looking at the data since 1999, the company’s average dividend yield was 3.1% and the current yield of about 7% represents well over 2 standard deviations above the long-term mean.

As the OXY/APC deal closes we expect OXY’s management team will issue more detailed guidance on free cash flow and CAPEX synergies in coming years and, over time, we’d expect investors to gain additional comfort level with the sustainability of the dividend. At a minimum, we’d expect the indicated yield to fall back toward the 5% level, about a full standard deviation above the long-term average.

Based on the current annualized dividend and a 5% indicated yield target, OXY would sell for $63.20 per share, about a 40% rally from the current level. OXY remains a compelling total return (capital appreciation and yield) investment at current prices and remains a buy in our Actively Managed Portfolio.

WPX Energy (NYSE: WPX)

WPX Energy (NYSE: WPX), a producer with exposure to both the Delaware Basin of the Permian and the Bakken Shale of North Dakota, reported blow-out results in Q2 2019.

In short, total production in Q2 was around 159,600 boe/day of which 61.3% was oil. That was ahead of the Wall Street consensus outlook for about 157,000 boe/day.

In addition, WPX both reaffirmed its CAPEX outlook for 2019 – a total of $1.1 to $1.275 billion in spending – and boosted its projected 2019 full-year oil production outlook from 96,000 to 100,000 per day up to 101,000 to 103,000 bbl/day. That's about a 4% hike in the guidance at the midpoint.

WPX has a total market capitalization of about $4.35 billion compared to CXO at $13.7 billion and OXY at $34.4 billion. Generally speaking, smaller producers are likely to take longer to move to “development” mode on their acreage and toward generating free cash flow. However, that's not the case with WPX – the company reiterated its guidance that it will generate $100 to $150 million in FCF in the second half of 2019 and will be free cash flow positive for the full year compared to negative $600 million in 2018.

And this plan is, like so many other E&Ps we cover, NOT based on some pie-in-the-sky outlook for commodity prices – WPX's plan is based on $50/bbl WTI and a mid-cycle price assumption of $50 to $55/bbl.

As WPX makes the turn to positive free cash flow, management had planned to start returning capital to shareholders through share buybacks and debt repayments in 2021. However, in a sign of confidence in the outlook, WPX has decided to accelerate those plans and announced a $400 million share buyback to be implemented over the next 24 months.

As management noted in its prepared remarks:

“The current market sentiment has created favorable circumstances for an action like this [a share buy-back] and if the market remains irrational, we will be opportunistic.”

Source: WPX Earnings Results Conference Call August 6, 2019

With WPX on track to deliver $100 to $150 million in free cash flow in the second half of 2019 and a further $300 million or more in free cash flow for 2020, even with WTI around $50/bbl, we agree the stock is
dramatically undervalued.

**WPX Energy remains a buy in the Actively Managed Energy & Income Advisor Portfolio.**

We covered the outlook for the services industry at some length in the last issue of *Energy & Income Advisor*, “Services: International Growth, Shale Changes”; however, here’s a quick review of two additional service-related recommendations that have reported Q2 2019 earnings results:

› **Core Laboratories (NYSE: CLB)**

Core Laboratories (NYSE: CLB) reported solid earnings in Q2 2019 though performance of its two main business segments – reservoir description (RD) and production enhancement (PE) continued to diverge.

The RD business, accounting for about 63% of Q2 revenues, saw sequential growth of 2% and was up 3% on a year-over-year basis. This business consists mainly of analyzing reservoir rock samples on behalf of energy producers to help optimize the way wells are drilled and the production plan for a project. It’s essentially the business behind Core’s name – Core labs does laboratory analysis of core samples.

The most important point to remember about the RD segment is that more than 80% of revenues are derived from outside the US and it’s heavily leveraged to offshore and, in particular, deepwater well development.

As we noted in the most recent issue of *Energy & Income Advisor*, Schlumberger saw a continued improvement in international spending growth and Core’s results reflected that improvement – international revenues were up around 8% year-over-year. A good part of this is due to the steady increase in deepwater spending, albeit from a low level over the past 18 months and we expect that strength to continue to flow through to CLB’s growth.

The problem for Core is the production enhancement (PE) division that’s heavily exposed to US shale oil and gas development activity. In this segment the company essentially produces analysis and diagnostic services for shale well completions so it’s been exposed to the boom and bust cycle in shale well developments over the past few years.

It’s important to note that we do believe PE will eventually see a lift as producers focus on technology as a means of reducing parent-child well interference issues and to drive the next wave of efficiency gains. However, for now, this division remains a drag on results and revenues were down another 4% sequentially in Q2 2019.

**With improvement underway in CLB’s larger RD division and the company likely to generate enough free cash flow to cover its 5.4% dividend payout over the intermediate term, we’re retaining our buy recommendation on the stock in the Actively Managed Portfolio.**

› **FMC Technologies (NYSE: FTI)**

FMC Technologies (NYSE: FTI) remains a notable standout performer in the services space – the stock is up 26.3% year-to-date compared to a decline of 15.6% for the Philadelphia Oil Services Index.

FMC is involved in multiple advantaged end-markets including deepwater and Liquefied Natural Gas (LNG) developments.

In deepwater oil and gas developments, much of the equipment used to produce hydrocarbons is typically installed in the seafloor. The list includes SURF, an acronym for subsea umbilicals, risers and flowlines.
In short, umbilicals are hydraulic hoses and cables that facilitate the control of subsea equipment from the surface, risers connect a subsea oil or gas well to the surface and flowlines transport production from subsea wells to a production platform.

The company manufactures such subsea equipment and engineers subsea developments including subsea pipelines that “tieback” new wells to existing production platforms.

Due to the aforementioned recovery in deepwater and offshore spending, orders for this equipment have been strong – in fact, in Q2 incoming orders for FTI’s subsea business totaled $2.6 billion in line with Q1 2019 and close to a record level.

Liquefied natural gas is simply methane (natural gas) that’s been supercooled into a liquid to facilitate transport. Given the rising importance of natural gas to the global energy picture, spending on new LNG developments has been solid in recent years and FTI builds and engineers these developments. Incoming orders reached a record level of about $8.1 billion in Q2 2019.

In addition, FTI is also involved in refinery, chemical and fertilizer plant maintenance and construction work – margins from these businesses can actually benefit from lower oil and gas prices.

Well positioned from a business line perspective for the ongoing “offshore and overseas” recovery in oilfield services spending, FTI remains a buy in our Actively managed Portfolio.