The Name of the Game is High Grading

By Elliott H. Gue and Roger S. Conrad

Unless there’s a monster rally in the last 10 days of March, oil prices are headed for their worst one-month performance in history. In fact, the decline so far is almost 17 percentage points greater than the previous record of -33 percent in October 2008.

Then as now, energy prices have been hammered by the growing likelihood of a global demand shock. That time around, the cause for concern was the Financial Crisis, which then had unknown dire consequences for economic growth. This time, it’s COVID-19 and its highly uncertain eventual impact on human health and the global economy.

Oil prices, however, simultaneously face a supply shock, as Saudi Arabia ramps up production even as demand comes under pressure. A similar move by the Saudis in 2015 was enough by itself to drive US prices down to $26 and change. This time around, combined with the demand shock, we now see a probability of oil prices in the mid-teens before there’s a hard bottom.

It’s fair to say that energy stocks have taken these negative developments very hard. The result is even the sector’s bluest blue chips have taken it on the chin.

Never in their long history, for example, have shares of Enterprise Products Partners (NYSE: EPD) yielded as much as 12 percent. Yet at one point last week, they were priced to pay out more than 15 percent. Super majors Chevron Corp (NYSE: CVX) and ExxonMobil (NYSE: XOM) raised their dividends more than once in the 1998-2002 period, a period when oil prices actually broke under $10 a barrel. Yet Chevron is now priced to yield nearly 9 percent and ExxonMobil over 10 percent.

Not even Saudi Arabia can afford $20 per barrel oil for long. Neither can Russia, whose refusal to cut output apparently led to the Saudis’ decision to turn on all the taps. That means both countries are eventually going to come back to the bargaining table, possibly sooner than second half 2020 if President Trump is able to follow through on his recent pledge to work a deal “at the appropriate time.”

But until there’s sufficient accurate data to forecast COVID-19’s eventual impact, uncertainty about the demand shock will continue to pressure oil. And that means energy stocks will continue to face a severe stress test with the potential to run many out of business.

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In our March 19 Alert “Don’t Head for the Hills, High Grade Instead,” we highlighted three reasons why we believe the strongest energy companies are still headed for an explosive recovery. That’s the fact that this is still an essential business, that the best-placed energy companies have always historically emerged from stress tests more dominant than ever, and that even the strongest are priced for dividend cuts. That means an extremely low bar of expectations to beat.

The two big questions we have to answer are when this recovery will occur and what will be the best stocks to own when it does. The first is unfortunately impossible to answer until there’s more clarity on future oil prices. And in fact, we believe there will be opportunities to bet on declines before that happens.

The second is, fortunately, well within our control to respond to. In the previous issue, we took a giant step toward “high grading” our model Portfolio toward the absolute strongest names in the energy sector. In this issue, we continue that process and affirm the reasons why we’re staying with other holdings, despite recent hits.

As we wrote in the Alert, this is not an easy process. But the payoff is we’re going to shape a portfolio of high quality stocks selling at prices now that will appear ridiculously cheap 12 to 18 months down the road. And if we do this right, our eventual gains will dwarf the losses we’re feeling now.

In This Issue

1 Feature: High Grading Energy at a Time of Stress, Some questions. Our evolving outlook for energy and our latest recommended steps to focus on the best of the best

2 Portfolios. We high grade our High Yield Energy List with some best in class names and review our other Portfolio Midstream holdings.

3 Endangered Dividends List. After the sharp drop in oil prices, almost every dividend paying energy stock is arguably pricing in a dividend cut. But risk is not all equal. Since our previous issue, oil and gas producers ARC Resources Ltd (TSX: ARX, OTC: AETUF) and Vermilion Energy Inc (TSX: VET, NYSE: VET) have both reduced their payouts. So have Bonterra Energy (TSX: BNE, OTC: BNEFF), Chemtrade Logistics (TSX: CHE-U, OTC: CGLFF), Crescent Point Energy Corp (TSX: CPG, NYSE: CPG), Occidental Petroleum (NYSE: OXY) and Whitecap Resources (TSX: WCP, OTC: SPGYF).

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 that aren’t favorable to current shareholders.
# High Yield Energy Target List

<table>
<thead>
<tr>
<th>Company</th>
<th>Exchange: Symbol</th>
<th>Date</th>
<th>Recent Price ($)</th>
<th>Yield (%)</th>
<th>12-Mo Dist Gr</th>
<th>Distro Coverage (times)</th>
<th>Debt/EBITDA</th>
<th>Total Return (%)</th>
<th>Advice</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enable Midstream LP</td>
<td>(NYSE: ENBL)</td>
<td>5/22/19</td>
<td>2.10</td>
<td>62.36</td>
<td>3.9</td>
<td>1.23</td>
<td>3.8</td>
<td>-77.4</td>
<td>Hold</td>
<td>Aggressive</td>
</tr>
<tr>
<td>Energy Transfer LP</td>
<td>(NYSE: ET)</td>
<td>5/22/19</td>
<td>5.25</td>
<td>23.24</td>
<td>0.0</td>
<td>1.88</td>
<td>4.0</td>
<td>-58.7</td>
<td>Buy&lt;15</td>
<td>Conservative</td>
</tr>
<tr>
<td>Enterprise Products Part</td>
<td>(NYSE: EPD)</td>
<td>3/20/20</td>
<td>14.56</td>
<td>12.30</td>
<td>2.3</td>
<td>1.70</td>
<td>3.4</td>
<td>0.0</td>
<td>Buy&lt;33</td>
<td>Conservative</td>
</tr>
<tr>
<td>Hess Midstream Corp</td>
<td>(NYSE: HESM)</td>
<td>5/22/19</td>
<td>8.86</td>
<td>19.12</td>
<td>15.1</td>
<td>1.20</td>
<td>3.4</td>
<td>-51.0</td>
<td>Buy&lt;24</td>
<td>Conservative</td>
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<tr>
<td>MPLX LP</td>
<td>(NYSE: MPLX)</td>
<td>5/22/19</td>
<td>11.73</td>
<td>23.44</td>
<td>6.2</td>
<td>1.42</td>
<td>4.1</td>
<td>-57.1</td>
<td>Buy&lt;25</td>
<td>Conservative</td>
</tr>
<tr>
<td>NuStar Energy LP</td>
<td>(NYSE: NS)</td>
<td>8/9/19</td>
<td>9.36</td>
<td>25.26</td>
<td>0.0</td>
<td>1.64</td>
<td>3.9</td>
<td>-60.6</td>
<td>Buy&lt;28</td>
<td>Conservative</td>
</tr>
<tr>
<td>Oasis Midstream Part</td>
<td>(NASDAQ: OMP)</td>
<td>6/6/19</td>
<td>4.57</td>
<td>47.58</td>
<td>20.0</td>
<td>2.20</td>
<td>2.3</td>
<td>-67.7</td>
<td>Sell</td>
<td>Aggressive</td>
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<tr>
<td>ONEOK Inc</td>
<td>(NYSE: OKE)</td>
<td>3/20/20</td>
<td>20.67</td>
<td>18.09</td>
<td>8.7</td>
<td>1.38</td>
<td>4.8</td>
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<tr>
<td>Suburban Propane Part</td>
<td>(NYSE: SPH)</td>
<td>6/6/19</td>
<td>11.54</td>
<td>20.80</td>
<td>0.0</td>
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<td>4.5</td>
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<td>Western Midst Part</td>
<td>(NYSE: WES)</td>
<td>8/22/19</td>
<td>5.28</td>
<td>46.16</td>
<td>3.2</td>
<td>1.23</td>
<td>4.6</td>
<td>-71.4</td>
<td>Sell</td>
<td>Aggressive</td>
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</tbody>
</table>

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</th>
<th>Date Added</th>
<th>Position Size</th>
<th>Price</th>
<th>Indicated Yield</th>
<th>Total Return</th>
<th>Profit/ Loss</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>MPLX LP (NYSE: MPLX)</td>
<td>05/04/17</td>
<td>150</td>
<td>11.73</td>
<td>23.44</td>
<td>-56.14</td>
<td>-987.79</td>
<td>Buy&lt;25</td>
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<tr>
<td>Texas Instruments (NSDQ: TXN)</td>
<td>05/01/18</td>
<td>50</td>
<td>97.60</td>
<td>3.69</td>
<td>-0.32</td>
<td>-15.43</td>
<td>Buy&lt;120</td>
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<td>Concho Resources (NYSE: CXO)</td>
<td>10/26/17</td>
<td>45</td>
<td>40.56</td>
<td>1.97</td>
<td>-59.03</td>
<td>-1077.47</td>
<td>Buy&lt;95</td>
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<tr>
<td>Core Laboratories (NYSE: CLB)</td>
<td>06/30/18</td>
<td>35</td>
<td>9.95</td>
<td>10.05</td>
<td>-90.66</td>
<td>-3944.83</td>
<td>Sell</td>
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<tr>
<td>Enterprise Products Partners LP (NYSE: EPD)</td>
<td>01/09/17</td>
<td>150</td>
<td>14.56</td>
<td>12.30</td>
<td>-35.35</td>
<td>-772.08</td>
<td>Buy&lt;33</td>
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<tr>
<td>Hess Midstream Partners LP (NYSE: HESM)</td>
<td>03/28/17</td>
<td>200</td>
<td>8.86</td>
<td>19.12</td>
<td>-45.00</td>
<td>-797.32</td>
<td>Buy&lt;24</td>
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<tr>
<td>Occidental Petroleum Corp (NYSE: OXY)</td>
<td>09/29/17</td>
<td>65</td>
<td>10.23</td>
<td>30.89</td>
<td>-76.62</td>
<td>-2517.50</td>
<td>Buy&lt;45</td>
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<td>Crestwood Equity Partners LP (NSDQ: CEQP)</td>
<td>11/06/17</td>
<td>120</td>
<td>5.03</td>
<td>49.41</td>
<td>-75.50</td>
<td>-455.72</td>
<td>Hold</td>
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<td>Northland Power (TSX: NPI, OTC: NPIFF)</td>
<td>11/27/17</td>
<td>150</td>
<td>17.05</td>
<td>5.08</td>
<td>1.73</td>
<td>44.36</td>
<td>Buy&lt;20</td>
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<td>WPX Energy (NYSE: WPX)</td>
<td>12/28/17</td>
<td>75</td>
<td>2.82</td>
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<td>-80.14</td>
<td>-169.50</td>
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<td>Marathon Oil (NYSE: MRO)</td>
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<td>160</td>
<td>3.56</td>
<td>5.62</td>
<td>-83.04</td>
<td>-2859.00</td>
<td>Sell</td>
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<tr>
<td>Plains GP Holdings (NYSE: PAGP)</td>
<td>06/14/18</td>
<td>328</td>
<td>5.99</td>
<td>24.04</td>
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<td>-1454.55</td>
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<td>Magellan Midstream Partners LP (NYSE: MMP)</td>
<td>01/02/18</td>
<td>30</td>
<td>29.73</td>
<td>13.89</td>
<td>-51.91</td>
<td>-463.01</td>
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<td>TechnipFMC (NYSE: FTI)</td>
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<td>50</td>
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<td>-79.15</td>
<td>-249.34</td>
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<tr>
<td>Schlumberger (NYSE: SLB)</td>
<td>08/15/18</td>
<td>135</td>
<td>14.28</td>
<td>13.98</td>
<td>-74.95</td>
<td>-1444.81</td>
<td>Buy&lt;$42</td>
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<tr>
<td>Kinder Morgan (NYSE: KMI)</td>
<td>02/19/19</td>
<td>200</td>
<td>12.35</td>
<td>8.10</td>
<td>-32.28</td>
<td>-797.33</td>
<td>Buy&lt;$22</td>
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<td>Pembina Pipeline Corp (NYSE: PBA)</td>
<td>09/16/13</td>
<td>75</td>
<td>16.09</td>
<td>10.90</td>
<td>-29.73</td>
<td>-358.73</td>
<td>Buy&lt;35</td>
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<td>TransCanada Corp (NYSE: TRP)</td>
<td>11/15/13</td>
<td>30</td>
<td>36.59</td>
<td>6.16</td>
<td>4.93</td>
<td>54.08</td>
<td>Buy&lt;50</td>
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<tr>
<td>Brookfield Renewable Energy Partners LP (NYSE: BEP)</td>
<td>09/16/13</td>
<td>20</td>
<td>35.87</td>
<td>6.05</td>
<td>100.00</td>
<td>717.40</td>
<td>Buy&lt;35</td>
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<tr>
<td>Energy Transfer (NYSE: ET)</td>
<td>03/03/20</td>
<td>100</td>
<td>5.25</td>
<td>23.2</td>
<td>-54.55</td>
<td>-286.36</td>
<td>Buy&lt;15</td>
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<tr>
<td>Exxon Mobil (NYSE: XOM)</td>
<td>03/03/20</td>
<td>55</td>
<td>32.74</td>
<td>10.6</td>
<td>-36.18</td>
<td>-651.48</td>
<td>Buy&lt;$65</td>
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<tr>
<td>ProShares UltraShort Crude Oil (NYSE: SCO)</td>
<td>03/23/20</td>
<td>30</td>
<td>37.74</td>
<td>N/A</td>
<td>New</td>
<td>New</td>
<td>Buy&lt;$44</td>
</tr>
</tbody>
</table>

As of 03/20/2020, Market Close. Source: Bloomberg, Energy & Income Advisor
Portfolio: More on High Grading

To call the High Yield Energy List we launched last May a disappointment so far would be the understatement of the year. The one thing that went right was that none of the initial 10 recommendations has cut its dividend, with the exception of EnLink Midstream (NYSE: ENLC).

That affirms our analysis of dividend safety, based on the five criteria highlighted above. And it sets the list members apart from the several score coverage universe energy companies that have cut and eliminated dividends in the last 10 months or so.

Unfortunately, in the sector selloff we’ve seen in recent months, even consistently increasing dividends has mattered little to share price performance. Neither has superior distribution coverage, aggressive debt reduction, shareholder-friendly changes in governance or any other measure of underlying business strength. Rather, everything to do with energy has sold off fast.

We continue to believe this is an essential industry, that the best in class will emerge from this ongoing stress test more dominant than ever and that share price gains will ultimately be explosive from these deeply depressed levels.

Unfortunately, the deeper this trough, the greater the likelihood that more energy companies will slash dividends and be forced to seek bankruptcy protection—which in turn will wipe out their current shareholders.

This means first and foremost that there are fewer companies we can really count on to weather this crisis and come out the other side. Certainly not every energy stock that’s taken on water is going under. But it’s critical to unload those at serious risk to doing so, even if that means locking in a significant loss on the position.

Last month, we removed two quite battered high yielding stocks from our Model Portfolio, Antero Midstream (NYSE: AM) and EnLink Midstream. Both sales involved taking significant losses. But they did save deeper losses, as both stocks have fallen considerably further since.

Both Antero and EnLink continue to control valuable energy midstream infrastructure in shale basins with considerable potential in a normal market. Unfortunately, they’re dependent on production plans of greatly weakened Antero Resources (NYSE: AR) and Devon Energy (NYSE: DVN), respectively. And while neither of these companies appears to be in danger of immediate default, risk will grow the longer energy prices remain depressed.

It’s possible Antero and other Appalachian natural gas producers will get some relief later this year from reduced production of “associated” gas, as oil-focused companies in the Permian and Bakken cut back on drilling. That would also be a net plus for Devon. But until we can get a real read on the hit to demand from COVID-19, it’s unlikely to show up in earnings and CAPEX. And until there is improvement, prospective risk outweighs potential reward in Antero Midstream and EnLink.
The same now appears true for two other midstream companies we’ve recommended that are also highly dependent on single producers: **Oasis Midstream Partners** (NYSE: OMP) and **Western Midstream Partners** (NYSE: WES).

While not Portfolio recommendations, exiting this pair will also lock in considerable losses, based on points of entry last summer. And it must be said that both companies’ Q4 results and most recent guidance was promising. But the dramatic steps now being taken by Occidental will almost certainly affect that company’s all-important utilization of Western’s assets, and very likely its ownership stake as well.

The same is true for **Oasis Petroleum** (NYSE: OAS), which contributes the overwhelming majority of Oasis Midstream’s cash flow. That company also faces a growing risk of bankruptcy, as its bonds maturing in November 2021 now trade at just 34 cents on the dollar.

Oasis Midstream is fresh off a 4.9 percent sequential distribution increase, while Western last month boosted its payout for the 27th consecutive quarter. And both stocks have snapped back off their lows from last week. **But with several best in class companies now trading at severely depressed valuations, they’re no longer among the best candidates for our High Yield Energy List.**

Two that are now are **Enterprise Products Partners** (NYSE: EPD) and **ONEOK Inc** (NYSE: OKE). As we’ve said several times during this latest escalation of the sector stress test, financial strength of primary customers is the most important differentiator for best in class companies that will emerge from this crisis more dominant.

Enterprise and ONEOK are both highly diversified by customers as well as geography. Both are also firmly investment grade, with Enterprise at BBB+ and ONEOK BBB with stable outlooks from S&P. Both have conservative distribution policies that in recent years have enabled them to mostly fund robust CAPEX with internally generated cash flow. And they both rely heavily on fee-based

### Midstreams' Exposure

<table>
<thead>
<tr>
<th>Company</th>
<th>Major Customers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Antero Midstream Corp</td>
<td>Antero Resources</td>
</tr>
<tr>
<td>BP Midstream LP</td>
<td>BP Plc</td>
</tr>
<tr>
<td>Crestwood Eq Partners</td>
<td>Chesapeake, Concho, ExxonMobil, Marathon</td>
</tr>
<tr>
<td>DCP Midstream Partners</td>
<td>Phillips 66, refiners and distributors</td>
</tr>
<tr>
<td>Delek Logistics Part</td>
<td>Delek Holdings</td>
</tr>
<tr>
<td>Enable Midstream Partners</td>
<td>ExxonMobil, several utilities and producers</td>
</tr>
<tr>
<td>Enbridge Inc</td>
<td>numerous producers and utilities</td>
</tr>
<tr>
<td>Energy Transfer LP</td>
<td>numerous producers</td>
</tr>
<tr>
<td>EnLink Midstream LLC</td>
<td>Devon Energy</td>
</tr>
<tr>
<td>Enterprise Products Partners</td>
<td>Vitol Holding BV, numerous producers</td>
</tr>
<tr>
<td>Equitrans Midstream Corp</td>
<td>EOT Corp</td>
</tr>
<tr>
<td>Genesis Energy Partners</td>
<td>numerous refiners, producers</td>
</tr>
<tr>
<td>Hess Midstream Corp</td>
<td>Hess Corp</td>
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<td>Holly Energy Partners</td>
<td>Holly Frontier Corp</td>
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<tr>
<td>Kinder Morgan Inc</td>
<td>numerous producers, utilities</td>
</tr>
<tr>
<td>Magellan Midstream</td>
<td>18 refiners, numerous producers</td>
</tr>
<tr>
<td>MPLX LP</td>
<td>Marathon Petroleum, numerous producers</td>
</tr>
<tr>
<td>Noble Midstream Partners</td>
<td>Noble Inc</td>
</tr>
<tr>
<td>NuStar Energy LP</td>
<td>Valero Energy, numerous producers</td>
</tr>
<tr>
<td>Oasis Midstream Partners</td>
<td>Oasis Petroleum</td>
</tr>
<tr>
<td>ONEOK Inc</td>
<td>numerous producers, midstreams, utilities</td>
</tr>
<tr>
<td>Pembina Pipeline Corp</td>
<td>Suncor, Canadian Nat Res, numerous producers</td>
</tr>
<tr>
<td>Philips 66 Partners</td>
<td>Phillips 66</td>
</tr>
<tr>
<td>Plains All-America Pipeline LP</td>
<td>numerous producers</td>
</tr>
<tr>
<td>Shell Midstream Partners</td>
<td>Royal Dutch Shell</td>
</tr>
<tr>
<td>TC Energy Corp</td>
<td>numerous producers and utilities</td>
</tr>
<tr>
<td>Western Midstream Partners</td>
<td>Occidental Petro</td>
</tr>
<tr>
<td>Williams Companies</td>
<td>numerous utilities and producers</td>
</tr>
</tbody>
</table>

Source: Companies 2019 10-K and related reports, Energy and Income Advisor.
operations, where returns won’t vary much with energy prices or even shale production cutbacks.

Further, both companies have been highly proactive responding to the one-two punch of COVID-19 triggered oil demand shock and the supply shock triggered in part by increased Saudi output. ONEOK a week ago announced a $500 million reduction in CAPEX guidance to a new range of $1.6 to $2.4 billion. The lower end of the range ensures financial strength if conditions fail to improve or worsen for producers, while the upper end gives management flexibility to take advantage of an unexpectedly fast recovery.

The moves also don’t affect the company’s 2020 forecast for EBITDA, Management may still elect to throttle back on its 9 to 11 percent annual dividend growth guidance the next couple years. But from a yield now more than 18 percent, that’s not much of a concern for the share price. Insiders have stepped up purchases on the drop in prices, as Wall Street analysts have become increasingly bullish. **Shares are a buy at less than one-third our highest recommended entry point of 75.**

As for Enterprise, our highest buy point is still 33, more than twice the current price. The company announced last week that it’s reviewing its CAPEX plans in coordination with major customers. CEO Jim Teague also affirmed “substantially all of our major growth capital projects are supported by long-term bi-lateral agreements,” as are current revenues.

As for the rest of the High Yield Energy List, we’re going to stick with these companies for the time being. After the recent wave of exits, the most exposed to current industry pressures now is **Enable Midstream Partners** (NYSE: ENBL).

So far there’s been no reason to doubt the long-term commitment of this partnership’s primary owners and co-general partners **Centerpoint Energy** (NYSE: CNP) and **OG&E Energy** (NYSE: OGE). Both of these companies are primarily regulated electric and natural gas utilities, which in previous economic down cycles has been a highly reliable business. And while Enable exposure has no doubt contributed to the weakness in their share prices this month, both remain firmly investment grade with BBB+ credit ratings and stable outlooks.

At this point, we don’t know what the full impact will be on Enable earnings of reduced drilling activity in Oklahoma, and a now likely pullback in the Bakken as well. But it should be pointed out that more than 90 percent of 2020 cash flows will be either fee-based or hedged. Also, the company's primary Bakken customer is a unit of ExxonMobil, while its pipeline and storage unit's key customers are a group of five regulated utilities including general partners Centerpoint and OG&E.

Gathering and processing is the biggest part of the business at 66 percent of Q4 gross margin. And that means a lot of uncertainty about cash flows this year. That’s also reflected in bond prices far lower—bonds of September 2029 yield more than 16 percent to maturity—than one would expect for a BBB-rated company with a stable outlook from Fitch, S&P and Moody’s.

But it’s hard to argue that priced to yield more than 62 percent the shares aren’t already reflecting a potential elimination of the payout. And selling for 13 percent of book value of assets with proven value, there’s a growing possibility the barely 20 percent of this company that’s publicly traded will be bought in by the general partners—at a fraction of the IPO price of $20 but a handsome premium to the current price. Insiders have been heavy net buyers the last six months. **Hold Enable.**

**Energy Transfer LP** (NYSE: ET) is another potential candidate for a buy in, with heavy insider buying so far in 2020 a possible sign. And with the shares at just 65 percent of book value, there’s a lot of room for an offer well above the current price and less than the IPO price of $21 in February 2006.

The company has offered a guidance update since announcing robust Q4 results in late February. The
agreements reached at the same time with an “undisclosed company”—our suspicion is a super major or large independent—are a good sign its customers are healthy. And they include major long-term system expansion with contracts in the Eagle Ford through 2034 and the Permian Basin through 2040.

With the stock now priced to yield north of 23 percent, investors are effectively betting on a major drop off in cash flow, given the Q4 coverage ratio of 1.88 times. And the company is again facing a legal challenge from the Standing Rock Sioux Tribe, who’s again petitioning to shut the Dakota Access Pipeline.

District Court Judge James Boasberg is expected to issue a ruling by the end of the month and a favorable ruling for the defendants—Energy Transfer and the US Army Court of Engineers—would effectively end the case. That could be an upside catalyst, while the defendants would almost certainly pursue an immediate injunction to keep the pipeline open in the case of a negative ruling.

For now, it’s just one more point of uncertainty for Energy Transfer shares. But from this price, our view is upside far outweighs risk of additional downside for this leading midstream, still a buy up to 15.

Hess Midstream Corp (NYSE: HESM) cut the mid-point of its 2020 EBITDA guidance by 4 percent, reflecting “lower than expected throughput volumes resulting from basin-wide lower rig activity.” To offset, the company is cutting 2020-21 expansion CAPEX by $200 million, resulting in a 12 percent lift in the mid-point of free cash flow guidance ($425 million).

Management also reaffirmed guidance for 25 percent EBITDA growth in 2021 from 2020 levels, as well as the fact that 90 percent of expected 2021-22 free cash flow is backed by MVCs—minimum volume commitments. Those MVCs are not affected either by energy price volatility or system throughput and they will fully fund capital needs including dividends, eliminating the need to sell new debt or equity.

Hess also announced it’s throttling back dividend growth for the time being to an annual rate of 5 percent, while targeting a boost in coverage to 1.4 times. But that’s hardly material with the shares yielding more than 19 percent.

The health of Hess Corp (NYSE: HES) as a major owner and customer remains very important to Hess Midstream’s long-term health and ability to weather this stress test. But despite the halving of that company’s share price this month, Hess Corp remains well positioned with a solid balance sheet and geographically diverse exploration and production portfolio, with output 80 percent hedged for the rest of 2020.

More important for Hess Midstream, Hess Corp’s Bakken production is low cost and located in the core of the formation’s most productive acreage. That’s where all of Midstream’s asset are and they’re 100 percent fee-based and fully contracted to Hess Corp. We continue to rate Midstream a buy all the way up to 24, which at this point is almost three times the current price.

Few investors seem to have paid attention to the decision announced by Marathon Petroleum (NYSE: MPC) this week to retain its relationship and ownership stake in MPLX LP (NYSE: MPLX). But the move eliminates considerable uncertainty that’s hung over the partnership’s unit price for nearly a year.

Marathon/MPLX still face considerable challenges, including the apparent failure to sell the Speedway fuels distribution franchise. But with Mike Hennigan now CEO, the focus now appears to be on streamlining rather than dismantling MPLX for the short-term gain of Marathon. That includes rejecting a proposal to “reverse drop down” the MLP’s more stable assets.

What we may see in coming weeks is a distribution cut at MPLX to speed up debt reduction, now that the energy price crash has probably taken asset sales off the table, at least temporarily. And speculation
is high that Hennigan will also look to convert MPLX to a corporate structure, under which shares are expected to command a higher valuation than they have recently as an MLP.

But given MPLX’ strong Q4 coverage of 1.42 times and relative lack of debt pressures—no maturities until September 2021 and bonds of April 2058 yielding just 6.8 percent to maturity—a prospective cut is likely overly priced in with the shares yielding north of 23 percent. Bottom line is this is still a solid mid-stream franchise. **Our recommended buy below price is still 25.**

NuStar Energy’s Q4 coverage ratio came in at 1.64 times. But that hasn’t stopped its share price from selling off to the point where the MLP yields north of 25 percent. The bear case is reduced activity in the Permian Basin, where management has focused the past several years. The company has not fully updated guidance since early February, leading many to assume the worst. That’s also reflected in the price of the company’s bonds of September 2020, which currently yield a distressed yield to maturity of 14.5 percent.

What we do know is NuStar insiders have stepped up their buying of the MLP’s shares since the price started dropping. That plus the fact that system volumes were rising robustly as of last guidance and the conservative steps management was already taking to hold in more cash may indicate risk to the payout is considerably less than the current price would indicate. So until we see a guidance update, our highest recommended entry point for NuStar is still 28.

As for Suburban Propane Partners (NYSE: SPH), it’s potentially the most mispriced of any of the stocks on our High Yield Energy list. In early February, the heating fuels distributor announced fiscal year Q1 distributable cash flow (end December 31) that covered both distributions and CAPEX, including the price of recent acquisitions.

Since then, the only significant business news was the refinancing of the $500 million senior secured credit facility on terms very favorable to the company. That included a more than 3-year maturity extension, an increase in maximum allowed consolidated leverage and reduced borrowing costs.

It’s possible propane sales could suffer in a prolonged US economic downturn, particularly what’s used commercially. On the other hand, the bulk of demand is tied to weather, which while affected negatively by mild temperatures tends to maintain a baseline. Management is also able to offset fluctuations with cost cutting. And there’s also the possibility that lower wholesale prices coupled with Americans’ need to stay home to combat COVID-19 could increase demand for cooking.

Either way, shares priced to yield more than 20 percent look more like a victim of market-wide selling than anything company specific. Our highest recommended entry point for Suburban is 24.

The Portfolio also holds several other midstream companies: Crestwood Equity Partners (NSDQ: CEQP), Kinder Morgan Inc (NYSE: KMI), Magellan Midstream Partners (NYSE: MMP), Pembina Pipeline (TSX: PPL, NYSE: PBA), Plains GP Holdings (NYSE: PAGP) and TC Energy (TSX: TRP, NYSE: TRP).

Of these, Crestwood has been beaten up the most. One likely reason is having Chesapeake Energy (NYSE: CHK) and Occidental Petroleum as major customers. We’re not so concerned with the latter, particularly in light of the gathering and processing agreement reached earlier this month in the Powder River Basin. We also believe exposure to what seems to be an increasingly likely Chesapeake bankruptcy is overstated, as the company’s contracts are essential to the latter’s ability to restructure.

Crestwood shares are obviously pricing in a big distribution cut with a nearly 50 percent yield, if not the total elimination of the payout. And its bonds are also deeply discounted, with the April 2023s priced at a yield to maturity of more than 25 percent.
But with 8 of 10 Wall Street firms rating the shares buy—actually an increase in bullish sentiment this year—and insiders net buyers this month, there’s a clear disconnect here. And with Q4 distributable cash flow coverage a full 2 times, it will take a substantial drop off to seriously threaten the payout.

Crestwood is primarily a G&P midstream, which means drilling activity can have a direct and immediate earnings impact. And until management updates guidance, there’s a cloud of uncertainty hanging over the shares. **But at this price, shares certainly rate a hold.**

Kinder Morgan won a major court victory this past week, as a Texas Judge allowed the company to continue work on the Permian High Pipeline. That should allow the project to start operating by the early 2021 target date. And the company also won approval from the Federal Energy Regulatory Commission to start up a fifth train at its Elba Island LNG export facility, which is under a 20-year contract with super major **Royal Dutch Shell** (NYSE: RDS/A).

Other than that, there’s been little news out of this highly diversified midstream, which will report Q1 results and officially announce its next dividend payment in mid-April. Current guidance is for a 25 percent boost, which at Kinder’s share price would take the yield north of 10 percent. That’s still our expectation. **Our buy target is 22 or lower.**

Magellan Midstream shares have lost roughly half their value this month so far, and are now priced to yield nearly 14 percent. That too is a disconnect from rising bullish sentiment on the Street—16 buys, 6 holds—and buying by corporate insiders, who have increased their ownership by nearly 17 percent over the last six months.

Adding to distribution security is the fact management was already anticipating slower energy patch activity, announcing a roll back of already conservative payout growth the past several years. CEO Mike Mears also declared back in January “the reality is we will most likely be a lower capital spending environment over the next few years.”

Until management updates guidance again, we expect some uncertainty to hang over the share price. But with a BBB+ credit rating and solid cash cushion—as well as a highly conservative operating strategy—we remain comfortable holding onto Magellan, and our buy target of 75 that’s nearly three times the current price.

Up until this month, shares of Pembina Pipeline and TC Energy had dodged the energy sector downdraft. But the meltdown of Canadian oil and gas producers noted in the Endangered Dividends sector has apparently triggered a revaluation of both stocks particularly Pembina, which is now priced to yield nearly 11 percent.

Pembina this week won FERC approval to build the Jordan Cove LNG export facility in Oregon. That project still faces hurdles, primarily on the local level. But the fact the company continues to push it forward is continuing testament to management’s ability to execute projects, which remains its primary driver of long-term growth.

Neither company is a stranger to energy patch weakness in Canada. Pembina was quick to react to the steep drop in selling prices, announcing a 40 to 50 percent cut in previous 2020 CAPEX guidance by deferring expansion of several projects to later years. That move won’t impact 2020 results and management took the opportunity to affirm 85 percent of EBITDA is from long-term, fee-based contracts—with 62 percent from capacity based contracts to strong counterparties like **Suncor** (TSX: SU, NYSE: SU).

The company has hedged much of the remaining commodity price exposure, which is concentrated at the marketing and new ventures division (15 percent of EBITDA). Some 80 percent of credit exposure is
investment grade, with the rest diversified across “various industries.” The dividend is entirely covered by the fee-based portion of EBITDA and then some, though management doesn’t plan another increase until the environment improves.

TC Energy raised its quarterly dividend by 8 percent in late February, while guiding to an equal hike next year and annual boosts of 5 to 7 percent “after 2021.” Management has yet to update guidance since announcing Q4 result in mid-February. But a “letter of intent” issued to acquire Pioneer Pipeline in mid-March for CAD255 million is a likely tipoff to how the company intends to use its superior balance sheet to increase strategic dominance during this downturn.

Despite recent price declines, TC has a very real cost of equity advantage over every major company in its industry, yielding just 6 percent. And it has a cost of debt capital edge as well, with its bonds of October 2049 yielding just 4.79 percent to maturity.

The upshot is we’re not likely to get any nasty surprises from either company as the energy sector stress test unfolds. **TC remains a buy up to 50 and Pembina to 35.**

Plains’ fate lies entirely with the fortunes of its ownership stake in Plains All-American Pipeline (NYSE: PAA). That company also has yet to update guidance since announcing strong Q4 results. And that’s likely hanging over the shares, which are now priced to yield more than 25 percent.

The company did put a major potential risk behind it earlier this month, settling civil charges dating back to the 2015 oil spill near Santa Barbara, California for just $60.6 million including cleanup costs. But the more important issue is going to be what happens to pipeline throughputs, particularly coming from west Texas.

Plains’ reliance on fee-based contracts and the de-emphasizing of the more volatile Supply & Logistics business should insulate distributable cash flow this year to a large extent. The focus on deleveraging rather than buying back stock and the throttling down of CAPEX the next few years should shield the balance sheet. And that coverage ratio of 2.05 times for Q4 provides a sizeable cushion for the distribution, even if distributable cash flow falls off a cliff.

We’ll have to wait and see what Plains management comes up with for future guidance in the coming weeks. But at this point, shares of both the MLP and the GP look priced for the worst already, leaving a lot of room for upside on something less bad. **We’re staying with Plains GP as a buy at less than one-fourth our maximum recommended entry point.**

The simple fact is that all US shale fields are unprofitable with oil prices at current levels.

Even the most profitable shale wells in the most prolific pockets of the Permian Basin likely require prices in the $35 to $40/bbl range to generate positive cash flow.

US producers dropped 19 oil rigs in the most recent week and that’s just the beginning with most major shale producers announcing significant cuts to their 2020 capital spending and drilling budgets and more cuts likely in coming weeks. That will result in a major, across-the-board decline in revenues for services firms with leverage to North America.

In this environment, our strategy for upstream energy companies (producers) is to focus on names that can survive a prolonged period of low oil prices.

Following the 1986 oil price collapse, there was a wave of failures and bankruptcies across the US energy industry; however, the companies that survived were ultimately able to capitalize on that collapse, buying up choice assets on the cheap.
Just consider, over just 4 months, WTI collapsed from $31.72/bbl on November 20, 1985 to a low of $10.42/bbl at the end of March 1985. Except for one brief period around the Gulf War in 1990-91, WTI did not trade above $30/bbl again until 2000.

Even the largest, best-capitalized US energy producers suffered over this time period. However, the survivors like ExxonMobil ultimately flourished – if you bought Exxon when oil hit highs over $30/bbl in late 1985 your gains over the ensuing 5 years still came to 146.6% despite the collapse in WTI prices, better than the 88.7% gain in the S&P 500 over a similar holding period.

There are three key determinants of a producer’s ability to survive the current environment, positioned to flourish in the eventual recovery: Hedges, quality of balance sheet and quality of reserves.

Let’s start with hedges and debt:

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Symbol</th>
<th>Oil (% Production)</th>
<th>2020 Oil Hedge (%)</th>
<th>Net Debt/EBITDA</th>
<th>5-Year BB Implied CDS</th>
</tr>
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<tbody>
<tr>
<td>Noble Energy Inc</td>
<td>NBL</td>
<td>37.4</td>
<td>53.6</td>
<td>7.5</td>
<td>653.0</td>
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<td>PDC Energy Inc</td>
<td>PDCE</td>
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<td>33.9</td>
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<td>77.0</td>
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<td>34.0</td>
<td>1.6</td>
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<td>Apache Corp</td>
<td>APA</td>
<td>50.5</td>
<td>0.0</td>
<td>25.4</td>
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<td>Marathon Oil Corp</td>
<td>MRO</td>
<td>50.7</td>
<td>26.7</td>
<td>1.6</td>
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<td>265.0</td>
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<td>0.0</td>
<td>1.9</td>
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<td>44.4</td>
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<td>0.0</td>
<td>1.6</td>
<td>595.0</td>
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<td>HighPoint Resources Corp</td>
<td>HPR</td>
<td>61.2</td>
<td>64.7</td>
<td>2.4</td>
<td>877.0</td>
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<tr>
<td>Pioneer Natural Resources Co</td>
<td>PXD</td>
<td>61.5</td>
<td>53.3</td>
<td>0.9</td>
<td>310.0</td>
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<td>Parsley Energy Inc</td>
<td>PE</td>
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<td>58.2</td>
<td>1.7</td>
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<td>Murphy Oil Corp</td>
<td>MUR</td>
<td>61.7</td>
<td>34.2</td>
<td>1.4</td>
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<td>WPX Energy Inc</td>
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<td>QEP Resources Inc</td>
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<td>929.0</td>
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<td>Penn Virginia Corp</td>
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<td>Callon Petroleum Co</td>
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<td>77.3</td>
<td>61.9</td>
<td>7.2</td>
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<td>Denbury Resources Inc</td>
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<td>97.4</td>
<td>70.9</td>
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<td>OXY</td>
<td>58.2</td>
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<td>692.0</td>
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<tr>
<td><strong>Average</strong></td>
<td></td>
<td><strong>47.2</strong></td>
<td><strong>3.5</strong></td>
<td><strong>688.4</strong></td>
<td></td>
</tr>
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</table>

Source: Bloomberg, Energy & Income Advisor
This chart includes some basic data for 27 North American Exploration & Production companies of various sizes. The table includes the percentage of 2020 oil production that’s currently covered by hedges, the company’s trailing net debt to earnings before interest, taxation, depreciation and amortization (EBITDA) and the 5-year implied credit default swap (CDS) for each firm derived from a Bloomberg default risk model.

Essentially, this CDS represents the cost of insuring the company’s debt over 5 years – the lower the CDS, the lower the risk of default.

Simply put, investors should favor E&Ps with hefty 2020 hedge coverage as this reduces exposure to current ultra-low commodity prices. The average 2020 hedge coverage for the 27 companies listed is 47.2 percent; however, it’s also important to understand how these companies have hedged their output.

For example, while Occidental’s hedge book is solid on paper, the company’s use of collars limits the efficacy of hedges when Brent oil prices are below $45/bbl (currently near $27/bbl).

We would also continue to favor companies with a relatively low Net Debt/EBITDA ratio and a low 5-Year Implies CDS spread.

Looking at this table, Active portfolio recommendation Concho Resources (NYSE: CXO) screens among the best. The company’s net debt/EBITDA is 2.2 times, well below the average for this group of 3.5 times and the implied CDS is under 300 basis points, less than half the average of 688 and second only to EOG Resources (NYSE: EOG).

CXO has no bonds maturing until 2025 and an undrawn $1.6 billion credit facility.

Moreover, the company has some of the highest quality reserves in the Permian Basin and the among the lowest cash flow breakevens of any US E&P.

Hedge coverage for 2020 stands at close to 70% of total oil production and the hedges are all swaps based on the price of Brent and WTI oil; unlike options collars, swaps continue to protect the company against lower prices regardless of how far oil falls. In addition, CXO has hedged 45.8% of 2020 natural gas production.

The company has been quick to react to the oil price collapse, announcing a 25% cut to its planned 2020 CAPEX plans and highlighting further flexibility to cut CAPEX and preserve cash. Management expects to provide a more detailed rundown of its CAPEX plans and strategy for managing through the current low commodity price environment at its upcoming Q1 2020 earnings release, likely at the end of April or in early May.

While CXO will be hit by lower oil prices like all E&Ps, we believe it’s among the best positioned to weather the current storms and benefit from the eventual recovery. We’re retaining CXO as a buy in the Active Portfolio under $95.

Marathon Oil (NYSE: MRO) has a decent debt position and a below-average CDS spread. In addition, the company’s Eagleford acreage has some of the lowest breakeven prices of any shale acreage in the US. The company has made great strides in improving efficiency and well productivity in both its Bakken and Eagleford acreage.

Before the recent collapse in oil prices, MRO looked to have a solid hedge book. However, a significant portion of the company’s 2020 hedges are through options collars, which limit protection below a WTI price of $47.84/bbl. Excluding those collars, the company has only hedged a little over one quarter of its 2020 oil production.
There’s also some risk of contract rate renegotiations at the company’s LNG project in Equatorial Guinea which is scheduled for 2023.

**In our March 3, 2020 issue of Energy & income Advisor, we advised selling one-half of the recommended position in Marathon Oil as part of our efforts to high-grade the portfolio. At that time, we didn’t foresee an OPEC+ price war; however, given the material change in the outlook since then, we’re recommending the sale of all remaining shares of MRO in the portfolio.**

Also, in our early March issue of Energy & Income Advisor, we advised selling ½ of your position in WPX Energy (NYSE: WPX).

Like Marathon, WPX is a solid, well-run company but it just doesn’t work at $30/bbl oil prices. The firm has more than half its 2020 production hedged and its balance sheet is better than average; however, it’s a relatively small company and that’s going to leave it struggling to survive if the current commodity price deck continues for more than a few months.

**We’re selling the remaining shares of WPX from the Active Portfolio.**

**Occidental Petroleum** (NYSE: OXY) remains the hardest decision stock among the independent E&Ps currently in the portfolio.

The company has outstanding assets and low-cost acreage in the Permian Basin as well as a slew of cash-generative assets outside of North America. As we’ve repeatedly stated, we believed the company could sustain its dividends easily with oil over $50/bbl and leverage CAPEX cuts to protect its payout down to around $40/bbl.

Back in January, a drop below $50/bbl looked unlikely with the global economy recovering from the 2019 soft patch and OPEC+ actively reducing output as part of their December 2019 pact. As recently as early March, we believed oil could hold $40/bbl if OPEC+ would act to reduce output further and extend their supply management policies through year-end.

However, that all went out the proverbial window amid the recent price war and the company has been forced to both slash its dividend and capital spending plans for 2020.

To complicate matters, the company also took on significant debt to finance last year’s acquisition of Anadarko Petroleum. Plans to sell additional assets to pay down that debt will be threatened by the fact that buyers are likely to hold back given the broader commodity price outlook and a looming global recession sparked by the coronavirus outbreak.

**On paper, the company appears to be in a tough spot; however, we’re retaining OXY in the Active Portfolio for now.**

The company’s recent CAPEX cuts have lowered its breakeven on oil to the low $30’s per barrel. While we believe prices will go much lower than that in the near-term, virus fears will eventually ease later this year and oil demand will rebound.

Moreover, as we’ll explain in just a moment, neither Saudi Arabia nor Russia can sustain oil prices in the $20’s per barrel or worse for long – eventually we believe both nations need to see oil at least in the $40’s to be comfortable.

We believe Occidental has additional levers to pull into 2021 including further cuts to CAPEX and the elimination of its remaining dividend.

Our final remaining exposure to producers in the Active Portfolio is through Exxon Mobil (NYSE: XOM).
Exxon has yet to revise its capital spending plans for 2020; however, management has indicated it’s reviewing those plans and changes are likely. Roughly two-thirds of the company’s CAPEX is directed at projects already underway, meaning there’s limited flexibility to reduce that capital spending.

However, it’s likely the firm’s largely discretionary drilling plans in the Permian Basin of the US will be curtailed significantly while management could also postpone final investment decisions on several international projects including its $30 billion Mozambique gas project.

This flexible CAPEX totals roughly $10 billion in 2020 so Exxon has plenty of room to maneuver in the short run to cope with the severe drop in commodity prices.

Then, of course, there’s XOM’s crown jewel – the company’s investment grade credit rating and ability to borrow at advantageous rates. Just last week, for example, the company completed a 5-part $8.5 billion bond offering with maturities from 5 to 30 years; the yield on the company’s 10-year bonds issued last week stands at just under 3.5%, a cost of capital most energy companies can only dream of.

The current dividend yield on shares of Exxon Mobil is over 10%, which is the highest since 1982. We believe XOM views its dividend as a strategic priority and is unlikely to cut the payout unless oil prices remain below $30 to $35/bbl for much longer than we currently expect.

Longer term, we believe XOM will be in a position to take advantage of carnage across the industry to act as a consolidator, buying up choice assets at discounted prices, much as it did in the last big commodity price cycle of the late ‘80s and 1990s. Exxon Mobil remains one of our top picks to buy right now and we’re retaining it in the Active Portfolio.

The picture is bleak for the services and equipment names in our portfolio near-term.

Fortunately, we recommended selling our remaining position in Halliburton in our March 3rd issue as the stock has significant exposure to the collapse in North American shale drilling activity this year.

Unfortunately, we did not recommend selling all of the portfolio positions in Core Laboratories (NYSE: CLB) and FMC Technip (NYSE: FTI) though we did recommend cutting our recommended positions.

We believe both companies provide mission-critical services for the global energy industry but, with no sign of a revenue upturn in sight, we believe both companies will struggle for the foreseeable future and we see few, if any, upside catalysts.

Thus, we recommend selling your remaining positions in both stocks.

While Schlumberger (NYSE: SLB) has also been hit hard this month, we’re retaining the stock as our sole oil services pick in the Active Portfolio. It’s long been our favorite services stock to own due to its hefty exposure to more stable international services spending and its technological leadership in complex oil and gas development projects.

While international spending is likely to fall near term, we believe the magnitude of the downcycle will be less severe and it’s likely to recover faster than shale services spend as the current commodity downdraft stabilizes.

SLB’s current dividend yield of nearly 14% implies considerable probability of a dividend cut in 2020 and we believe that’s a distinct possibility, but is by no means assured. In the near-term, SLB has the scope to dramatically cut its 2020 capital spending budget to preserve cash and has considerable room on undrawn credit lines. The company also views its dividend as a strategic priority and is likely to hold the line as long as possible.

We believe that longer term SLB is likely to gain market share amid this commodity price downturn and will be positioned well for the eventual recovery. We’re retaining the stock as a buy in our Active Portfolio.
Lastly, given the potential for an even steeper drop in oil prices over the next few months, we’ve decided to initiate a small hedge position to help offset near-term pain from commodity price downside.

In particular, we’re recommending a 30-unit position in the ProShares UltraShort Crude Oil ETF (NYSE: SCO) as a buy under $44.

The ProShares Crude Oil ETF is designed to rise in value by 2% for every 1% daily fall in the price of West Texas Intermediate (WTI) crude oil. This is a volatile fund that traded in a particularly wide range last week between about $27.68 and $67.35. Because this ETF carries so much risk, we’re recommending only a small position size right now.

Normally, we’ve only recommended SCO as a way to trade short-term swings in the oil market in our short-term trading service, Pig vs. Bear. However, given the looming, historic glut of oil the world faces over the next two months and the ongoing demand-side hit from the COVID-19 outbreak, we see risk of a short-term dive in oil to the mid-teens.

Such a move, even if temporary, will likely hit energy stocks across-the-board, even including the remaining high-grade names in the Energy & Income Advisor Active Portfolio. That said, if oil were to hit $15/bbl over the next few weeks, SCO is likely to spike to around $70, producing a considerable gain on our recommended position in this ETF and helping to ease the pain of losses elsewhere in the portfolio.

The biggest risk here is that ultra-low oil prices drive Saudi Arabia and Russia back to the bargaining table to push through emergency supply cuts aimed at pushing oil prices back toward $40/bbl. Of course, this would produce significant losses in SCO.

However, we see three factors limiting that risk.

First, prior to the latest, failed OPEC+ meeting, the cartel had been pursuing a managed supply adjustment process for crude oil. Simply put, at the start of 2020 with US shale producers cutting back on CAPEX and targeting free cash flow over production growth, US supply growth was on target to slow dramatically this year and even fall slightly next year.

In the near-term, however, production momentum in US shale coupled with project start-ups in Norway and Brazil threatened a temporary oversupply of oil concentrated in the first half of this year. OPEC+ appeared willing to help offset the near-term glut to prevent a larger drop in oil prices to below $50/bbl by cutting their own output.

The idea was that a combination of solid global oil demand growth in 2020 and falling shale supply growth by the end of the year would tighten supply/demand balances over the next 12 months. Eventually, that would allow OPEC+ to restore curtailed output.

That managed supply adjustment process became more difficult as it became clear that the coronavirus outbreak would further curtail demand through at least the first half of 2020.

Then, of course, Russia balked at the 1.5 million bbl/day of additional cuts proposed by OPEC. While Russia has never really met its production commitments with OPEC, we believe the Saudis needed at least some contribution from Russia to give an OPEC+ deal some level of credibility. When they were unable to attain that commitment, the deal collapsed, and the following weekend Saudi Arabia decided to punish Russia with the largest-ever oil supply increase in history.

Russia miscalculated.

While the country is less dependent on oil revenues than most of the OPEC producers, including the Saudis, the country’s budget was based on Brent oil prices around $42/bbl. With oil trading $15 to $20/
bbl below that price right now and President Vladimir Putin recently committing to additional social spending, the country now faces sizable deficits.

Consider these dramatic shifts:

The Russian ruble traded at around 61 to the US dollar as recently as early January; today, the exchange rate is around 80 per dollar. Meanwhile, Russia’s 10-year bonds, which yielded around 2.5% in early March saw yields jump as high as 4.71% last week.

Saudi Arabia also faces considerable pain. The country’s reserves are down by one-third since the last time the kingdom sparked a global oil price war in 2014. Given the need to maintain social spending to prevent unrest and a credible level of reserves to maintain the Saudi riyal’s peg to the US dollar that’s been in place since 1986, Saudi Arabia is also not in a position to allow current ultra-low commodity prices to persist for as long as they did in 2014-16.

However, there is one long-term benefit of the price war to both Saudi Arabia and Russia – the gradual decline in US oil production growth we expected early this year has now been replaced with a step-change in the supply outlook.

Simply put, US shale supply growth is set to decline sharply this year and, even if prices were to recover by year-end, we believe producers will be slow to respond with higher capital spending.

In short, having just abandoned a gradual supply adjustment regime in favor of a shock-and-awe price war, it would be illogical for Russia and Saudi Arabia to suddenly reverse course yet again. At this point, it’s more likely the countries will wait at least a few months and look for irrefutable evidence of falling US shale output.

At a minimum, we wouldn’t expect a new deal before at least the cartel’s next scheduled meeting in May/June. Adding to the problem is that neither Saudi Arabia nor Russia can back away from the price war without publicly losing face and appearing to have “caved,” an important consideration given the personalities involved in both countries’ energy industries.

Second, as we’ve long said, all oil price cycles are driven by a combination of both supply and demand; however, cycles are typically dominated by either supply or demand. For example, the 2008-09 oil price rout was a demand-led cycle caused by a drop in demand amid the Great Recession while the 2014-16 cycle was led by supply and a change in Saudi policy.

This cycle is a black swan – a downcycle driven by both supply AND demand.

Even if Saudi and Russia were to agree to a deal today to address the historic oversupply of crude oil in global markets, that would do nothing to offset the near-term hit to global demand caused by the Wuhan coronavirus outbreak.

We won’t even hazard a guess for how long it will take for the current virus outbreak panic to abate or how many weeks/months it will be before global governments begin to lift travel bans and quarantine orders that have brought the global economy to its knees this month. However, it’s unlikely to happen in the next few weeks at a minimum.

Finally, while ProShares UltraShort Crude Oil is a risky, volatile ETF to own in isolation it’s less risky when combined with the other recommendations in the EIA Active Portfolio. Simply put, if our view that oil prices drop into the tends proves too bearish and oil does rebound faster than we expect, any losses in SCO would be more than offset by dramatic gains in our energy stock recommendations.

We’re recommending a 30-unit position in the ProShares UltraShort Crude Oil ETF (NYSE: SCO) as a buy under $44. We must stress, yet again, that this is a risky position and you should set your position size accordingly.
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.

**ARC Resources Ltd** (TSX: ARX, OTC: AETUF), **Bonterra Energy** (TSX: BNE, OTC: BNEFF), **Chemtrade Logistics** (TSX: CHE-U, OTC: CGIFF), **Crescent Point Energy Corp** (TSX: CPG, NYSE: CPG), **Occidental Petroleum** (NYSE: OXY), **Vermilion Energy Inc** (TSX: VET, NYSE: VET) and **Whitecap Resources** (TSX: WCP, OTC: SPGYF) have cut dividends since the previous issue of EIA.

The sharp drop in the price of Western Canada Select (WCS) oil was the primary catalyst for cuts at ARC, Bonterra, Crescent Point, Vermilion and Whitecap. WCS at one point last week sold for less than $10 a barrel. The price of Implied Bitumen produced in the country's prolific oil sands region is currently a little over $7 a barrel.

Canadian oil has traded at a sharp discount to US oil benchmarks for more than a few years, largely due to a lack of sufficient pipeline capacity out of the region to the US and world markets. Major projects like Enbridge Inc’s (TSX: ENB, NYSE: ENB) Line 3 expansion in Minnesota, TC Energy’s (TSX: TRP, NYSE: TRP) Keystone XL and the Canadian government’s TransMountain Pipeline are still slogging their way to completion. And Enbridge last week still says a 2020 start date is “possible” for Line 3.

Until there is new transportation capacity, however, Canadian energy producers will continue to face even greater challenges to cut costs than their US shale counterparts. Coupled with sharp cutbacks in CAPEX, the dividend cuts will buy time for all of these companies, which up until the Saudi supply shock had actually been managing their sector's depression conditions.

ARC, for example, now has just CAD30 million in maturing debt through the end of 2021. And its CAD950 million credit line is now completely undrawn. The combination of a 60 percent dividend cut, price hedging and a 40 percent reduction in previous CAPEX guidance to “no more than CAD300 million” should ensure that operating cash flow covers all capital needs, with production coming in at 150,000 to 155,000 barrels of oil equivalent per day. That should ensure ARC’s survival no matter how far oil and natural gas prices fall. **Hold.**

Bonterra announced it’s suspending dividends entirely starting in April. That coupled with stepped up hedging and a cut in planned CAPEX should also ensure full self-funding for now, allowing the company to tackle the CAD190 million drawn on its CAD325 million credit line maturing in April 2021. But we see better bets among producers. **Sell.**
Crescent Point this week cut its 2020 CAPEX budget by 35 percent, slashed its dividend 75 percent, suspended share buybacks and reduced production guidance by 10,000 BOE per day to 132,000. Management expects to be able to fully fund CAPEX at a West Texas Intermediate Crude price in the low USD30 per barrel range for the remainder of the year.” That’s unfortunately not a given and it may complicate attempts to roll over the CAD226 million in debt maturities this year. Crescent has great light oil assets. But investors are better off out until the dust clears.

Vermilion was spared the worst of the 2015-16 slide in North American oil prices, as natural gas prices in Europe and Australia largely offset the damage at home. But with the flood of LNG imports to Europe, those large price differentials don’t currently exist. So while the company’s operations have remained efficient and its balance sheet strong, it’s been hit hard by falling oil and gas prices globally.

After a 91 percent dividend cut and reduction in 2020 CAPEX guidance to a mid-point of CAD90 million, management should be able to generate positive free cash flow. And with no maturing debt until 2023, that should enable the company to survive. Potential credit rating downgrades are a concern but we rate Vermilion a hold.

Whitecap is cutting its quarterly dividend in half and the mid-point of 2020 CAPEX guidance to CAD205 million from the previous CAD360 million. The mid-point of expected output is now 67,500 BOE per day, down from the previous 71,500 BOE. The company has no debt maturities until 2023 and debt to EBITDA of just 1.6 times. But with a free cash flow breakeven point of “low $30s per barrel” of oil, it’s at risk to further price declines. And investors are better off elsewhere. Sell.

After weathering the 2008-09 Bear Market and Great Recession—as well as the 2015-16 oil price collapse—Chemtrade Logistics’ dividend policy wasn’t conservative enough to weather the COVID-19 crisis. As a result, the specialty chemicals producer is cutting its payout by 50 percent.

Management expects to use the saved cash to reduce debt leverage, presumably starting with the CAD839 million drawn on the CAD1.3 billion credit line maturing in October 2024—its most expensive source of funds. Alternatively, it may elect to make open market purchases of convertible bonds due in 2021 and 2023, both of which trade at sharp discounts to par value.

Unfortunately, the price and demand outlook for specialty chemicals produced by ChemTrade is now highly uncertain because of COVID-19’s unknown future impact on industrial activity. Consequently, investors are better off out of this stock as well, at least until there’s more clarity and how far growth will sink this year.

Finally, Occidental Petroleum is now moving very aggressively to tackle its $39 billion debt pile. The reduction in the quarterly dividend to 11 cents per share from the previous 79 cents is one such step. Naming former CEO Stephen Chazen as its new CEO to appease activist shareholder Carl Icahn is another. And free ranging talks with debt and equity investors on future strategic moves is a third.

Those actions apparently didn’t come fast enough to prevent Moody’s from cutting the company’s credit rating to junk last week. But we still see Occidental as offering tremendous value at these levels, for the assets it acquired with the former Anadarko alone. Our buy target remains 45 or lower. Note that earlier this month we added to our Model Portfolio position.
High Grading Energy At A Time of Stress: Some Questions

Q. From your comments you clearly expect to see more pressure on energy stocks. Why shouldn’t we just sell everything now and wait for a bottom?

A. Fair question. There are basically three reasons. First, market history teaches us that when energy does hit a final bottom, spotting it will be much more a matter of luck than insight or skill. And in any case, it won’t really matter much since anyone who’s invested within say 10 percent or so of the bottom will realize almost all of the upside from the recovery, provided they’re in the right stocks.

It’s also true that the hardest time to invest emotionally is likely to be at the bottom, which means almost no one is going to make that move to buy there. The best way to avoid that kind of paralysis is to scale into positions in best in class companies gradually when prices are low, i.e. close to the bottom as we’re doing now in Energy and Income Advisor.

Second, energy sector stocks aren’t going to touch their individual bottoms at the same time. It’s quite possible, for example, that even if oil hits $15 a barrel, Enterprise Products Partners won’t take out the low point of $10.27 per share it hit on March 18.

Sector indexes by definition include the bad and ugly of an industry as well as the best in class. Odds are the longer this cycle continues, the further weaker fare will drop, dragging the indexes like the S&P Energy Index and Alerian MLP Index lower even as the Enterprises of the world find their footing. And if you wait for those indexes to stabilize, chances are you’re going to miss significant moves in the stronger fare that investors will gravitate back to first.

Our approach of high grading holdings—swapping weaker for stronger stocks—is admittedly gradualist. And as we saw this past month, it always runs the risk of adding positions that immediately shed value at least temporarily. But it also ensures we will have those positions in place in the stocks we want when the market inevitably does turn. And again, we won’t run the risk of paralysis by analysis when it comes to pulling the trigger to get back in.

Finally, there’s the matter of dividends. The increased intensity of the energy sector stress test with the COVID-19 hit to demand and Saudi pumping up of supply we think ensures more dividend cuts. And in some cases, it’s likely to push companies into bankruptcy.

But it’s at least equally likely that because of the risk at the weaklings investors are painting the sector with too broad a brush. As we’ve pointed out in this issue, not every midstream company is burdened by excessive leverage, mired in highly cyclical projects with suspect counterparties or paying out too high a portion of earnings as dividends.

In fact, as we’ve pointed out in past issues of EIA, at least a dozen companies have been systematically reducing balance sheet and operating risk since oil prices started falling in earnest back in late 2014. And while there is risk that progress will stall in the face of the current challenges, these moves mean that more than a few companies are better positioned than they were the last time oil prices were in this range back in early 2016.

If we can identify them, we can buy best in class companies trading historically cheaply relative to their dividends. And as they prove their resiliency—even the ability to maintain a just good portion of those
payouts—we’re going to realize truly massive capital gains from these levels, in addition to big time distributions.

Energy stocks have been unpopular for a long time. And at this point, it’s hard to remember when they weren’t. But one thing hasn’t changed: This is a cyclical industry. There’s always another round turn ahead and when it comes it will be hard to believe prices ever got this low for the likes of Enterprise and ExxonMobil.

Again, all you have to do is look at the coverage universe tables on the EIA website to see we’re far from bullish on every energy stock. We continue to believe there are too many owners and operators of midstream companies, for example. But the best in class have at this point been thrown out with them. And that’s where the opportunity lies.

**Q. As you point out in the Endangered Dividends List section, there’s been a meltdown of Canadian energy producers. Will this group ever recover?**

**A.** Again, energy is a cyclical business and Canadian producers have been in a depression for some time. That’s good reason to remain cautious of most companies there. And if you look at the table of “Canada and Australia” stocks on the EIA website, you’ll see that many if not most stocks are rated sells, despite some pretty big hits to share prices already.

That said, something else is going on in the Canadian energy patch. That’s basically a weeding out of producers, and to a lesser extent midstream and services companies, that can’t survive the lower selling prices. And the more names disappear, the greater the potential dominance of those that remain.

That’s why, at the same time we’re advising sell on most Canadian E&P’s, we’re still recommending blue chips like Canadian Natural Resources (TSX: CNQ, NYSE: CNQ) and Suncor (TSX: SU, NYSE: SU). By the way, the midstream sector there has already consolidated greatly, which is why concerns about the Big Three’s earnings—Enbridge, Pembina and TC Energy—in 2020 are likely overblown.

It’s also worth noting that the US dollar’s runaway strength has had a direct and negative effect on the US dollar value of all Canadian stocks this year, with the Canadian dollar slipping to just a bit over 68 US cents. Given the US dollar’s status as a safe haven currency during global crises, this is likely to be a headwind for Canadian stocks until there is clarity on COVID-19’s ultimate economic impact. But long-term, a return to a more historically normal exchange rate of around 80 US cents is a pretty nice potential tailwind.

I don’t think we’ll see Canadian energy stocks valued on a par with US energy unless and until some of the major pipelines like Line 3 and Keystone XL are built. Until they are, Canadian oil and gas is going to be handicapped when it comes to getting to market and prices will almost surely be discounted relative to US benchmarks. But at their current discount, there’s still plenty of room to narrow the gap.

Again the key is simply for companies to weather the crisis as businesses. And the biggest and strongest in the sector have what it takes to do that, just as the best in class in the US do.

**Q. What would convince you that you’re wrong about an eventual recovery in midstream?**

**A.** Were we to see a nationwide ban on hydraulic fracturing, shale production would dry up and so would the need for much of midstream infrastructure now in place. That now looks extremely unlikely anytime soon, with Democrats apparently nominating a pragmatist for president rather than an ideologue.
Certainly, the keep it in the ground movement is more energized and well funded than ever. And certain high profile projects like Keystone are likely to continue seeing challenges. But the impact so far has been to restrict capacity and make existing projects more valuable, which we think will actually help best in class midstream companies weather the current stress test.

It’s also become fashionable to talk about the replacement of oil and gas with renewable energy and electric vehicles. But as we’ve pointed out here many times, the numbers so far don’t back up the theory. And don’t forget that even under the most aggressive forecasts for solar and wind deployment, global natural gas usage is expected to rise by around 40 percent by mid-century. That’s a lot of fresh demand and at current trends US LNG will feed a great deal of it.

One question we’ve gotten a lot from readers is whether or not current US midstream share prices indicate real bankruptcy risk. The answer is definitely yes for some companies. And we’ve been advising sells on many of them long before COVID-19 risk became a major market catalyst.

As we wrote in the Portfolio section, there are several holdings that have yet to update guidance in the wake of energy market developments this month. Until they do, there’s a chance we’ll see something truly unexpected that will deliver another hit to share prices. And that may be a good reason to swap them out.

But at this point, it looks to us like a lot of bad news is priced in for companies that up until this month were proving their resilience. And while the market always prices in the worst when faced with uncertainty, we don’t see a lot of risk to wait around to see what actually happens.