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# Special Situation: Oil Bonds

## Staying Calm During the Storm

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### Overview

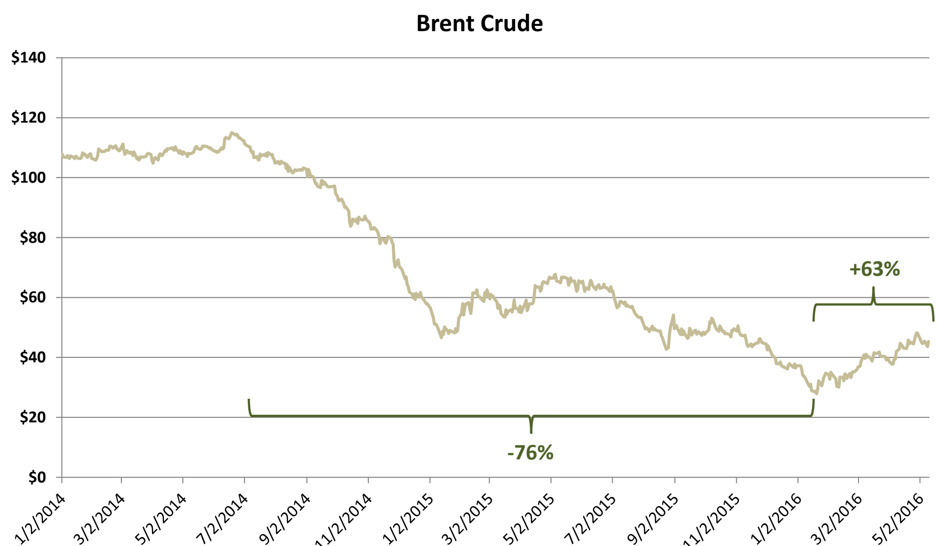
Current ultra-low global rates have made it difficult to achieve reasonable returns from holding run-of-the-mill, investment grade debt. Our approach in this rate environment is to form the core of our portfolios around plain-vanilla debt and accept the consequence of low returns. However, to supplement portfolio yields, we add 'satellite' positions in what we term "special situations". This core + satellite approach enables us to control our interest rate risk while achieving returns through credit quality changes.

We define special situations as issuers which have generated negative headlines or which operate in hard-hit sectors, *but whose bonds we believe remain fundamentally sound investments*. Markets and rating agencies sometimes overreact to bad news which provides opportunity. This was the philosophy behind our recent purchases of taxable oil bonds. As we wrote in our February 22 *Energy Update*, contagion from the high-yield ("HY") energy sector, pummeled by oil's dramatic price decline, spilled over into investment grade energy bonds. Prices dropped and yields soared. After thorough fundamental modeling and research, we concluded that certain issuers were trading at levels that weren't justified. Below is an update on our original rationale, and our current thinking.

### Background

The American shale oil/fracking revolution fundamentally altered energy markets. The large rise in US production led to a sharp uptick in supply amid soft global demand. As a result, oil prices declined from their 2014 high of $114/bbl to just $28/bbl by January 2016 - a stunning 76% drop.

This price decline hit bonds issued by oil-related companies particularly hard. Many ran into trouble as the market lowered perceptions of their creditworthiness.



Source: Bloomberg

Investment grade oil companies began to experience price declines in January as a result of contagion from the rout in HY oil bonds and a round of widespread Moody's rating downgrades. Portfolio managers seeking to reduce energy exposures were forced to sell their liquid investment grade oil bonds, creating a supply/demand mismatch that led to price declines. In turn, other portfolio managers watched their investment grade oil bond prices drop, and responded with additional selling that further exacerbated the mismatch.

**Our Strategy**

Recognizing this situation might generate attractive opportunities, we sought to identify the oil companies whose operating results, free cash flow and balance sheets were sufficiently robust from a bondholder's perspective. We researched industry trends and constructed detailed, multi-year financial models to stress-test each company's ability to continue meeting debt service requirements, prioritizing important characteristics such as:

- Existing capital plans, stock dividends, and stock buyback programs (which could be reduced or eliminated to conserve cash)
- Ownership of significant physical assets (which could be sold to raise funds)
- Cash flows which easily covered operating expenses and interest payments
- Balanced capital structures
- Access to bank credit lines

As a result of this analysis, we identified bonds of the companies in the table below as trading well below what we perceived to be fair risk-adjusted values. We added positions in each of these companies in January/February.

Prices for each of these bonds have since rebounded from their Q1 lows. This is partly attributable to oil's 63% rebound from recent lows (from $28/bbl to over $45/bbl), which, along with the Street's better understanding of each company's specific risks, has helped moderate market sentiment and reduce fears of cascading bankruptcies and industry contagion. Moreover, these price rebounds do not account for the additional income benefits from annual coupon payment.

| Company | Maturity | Prior Credit Ratings | Current Credit Ratings | Average Purchase Price | Current Market Price | Average Yield at Purchase | Current Yield to Maturity |
|---|---|---|---|---|---|---|---|
| **Exxon Mobil** | 3/15/19 | Aaa/AAA | Aaa/AA+ | $100.74 | $101.42 | 1.55% | 1.29% |
| **Royal Dutch Shell** | 8/21/22 | Aa2/A+ | Aa2/A+ | $95.71 | $99.88 | 3.11% | 2.39% |
| **Chevron** | 12/5/22 | Aa1/AA- | Aa2/AA- | $95.67 | $99.47 | 3.06% | 2.44% |
| **Occidental Petroleum** | 2/1/22 | A3/A | A3/A | $98.65 | $105.27 | 3.38% | 2.10% |
| **ConocoPhillips** | 1/15/20 | Baa2/A | Baa2/A- | $104.84 | $114.04 | 4.64% | 2.01% |
| **Noble Corporation** | 3/15/17 | B1/BBB | B1/BBB | $95.75 | $98.25 | 6.90% | 4.62% |

*Source: Bloomberg*

**Conclusion**

Treasury Partners continues to closely monitor our oil bond positions and the macroeconomic trends which impact crude prices. While the direction and level of oil price changes may remain volatile, we believe the companies in which we've invested are well-equipped to weather any persistent declines. We remain comfortable maintaining these positions in client accounts.

## Disclosure

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