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# DEATH IN THE OIL PATCH

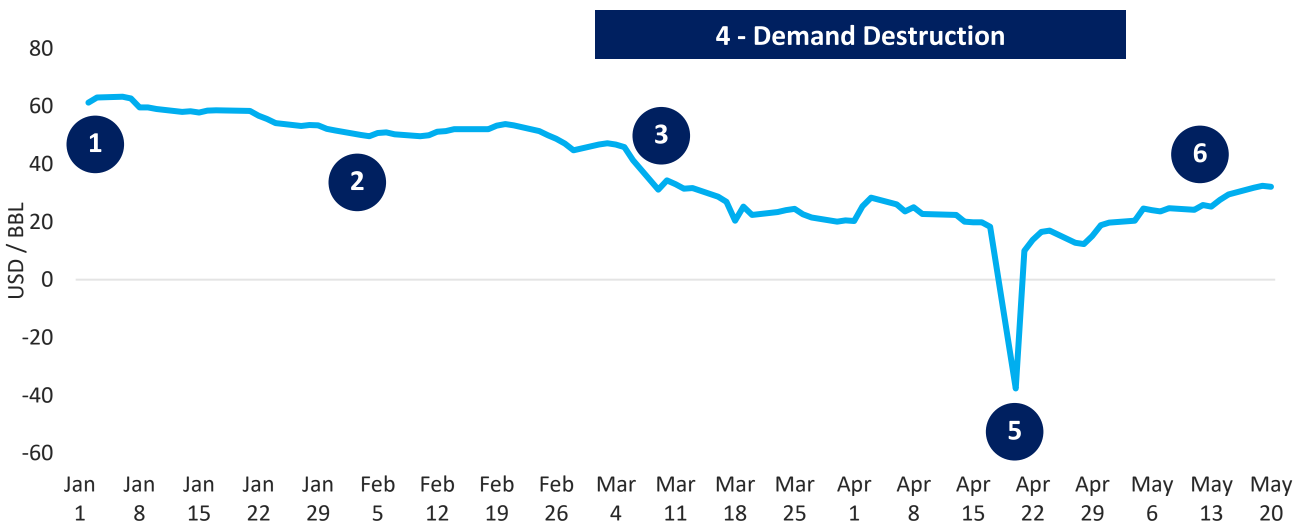
"There are decades when nothing happens;
and there are weeks when decades happen." –Vladimir Lenin

At the beginning of 2020, it appeared that the beleaguered U.S. energy sector was beginning to show early signs of a recovery, albeit with some lingering issues from the five-year downturn. Instead, a perfect storm in the first quarter of 2020 resulted in a 66% decline in oil prices for the quarter, with natural gas prices declining *only* 25%.[1] A confluence of events pushed the energy sector into a downward spiral the likes of which the industry had never experienced. Words like *volatile*, *unprecedented*, and *perilous* only partially captured the full extent of the events in the first four months of the year.

Indeed, the first part of 2020 felt like *death in the oil patch*. While energy markets stabilized through May, looking ahead, we see continued challenges, as global demand destruction could bring a new wave of bankruptcies of public companies and restructurings for private energy managers. As the final shakeout in energy occurs, those companies and managers that survive may be well-positioned for the future.

The following is a brief timeline of the events that defined the energy sector in the first four months of 2020.

**ENERGY SECTOR TIMELINE AND WTI FRONT MONTH CONTRACT PRICE**




*Data source: WTI Front Month Contract Price. Data as of 4/20/2020.*

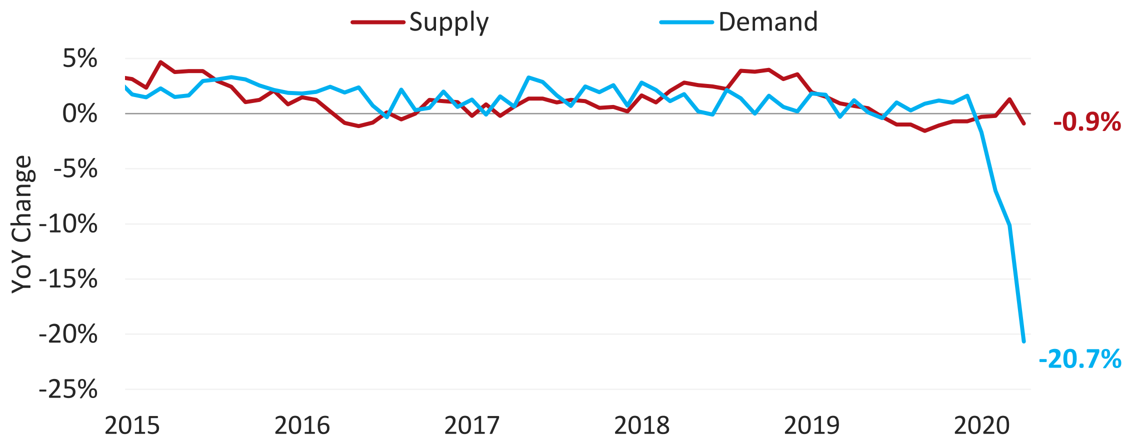
1. **January 2020** – Oil began the year trading at $61/barrel and briefly traded higher on news that an Iranian military leader had been killed in a strike authorized by the United States. Oil prices then fell into the mid-$50/barrel range. In late January, Southland Royalty, an EnCap-backed private energy company, declared bankruptcy in one of the highest profile failures in private energy.[2]

2. **February 2020** – U.S. oil production reached a record 13 million barrels per day. Equity markets also reached all-time highs, with the S&P 500 hitting nearly 3,400 on February 19. Oil traded down into the mid $40/barrel range on concerns about slower economic growth in China due to the emerging novel coronavirus.[3]

3. **March 6, 2020** – After OPEC failed to reach an agreement on production cuts, Saudi Arabia and Russia entered into a price war. Saudi Arabia immediately moved to *increase* production, and sent shockwaves through an already precarious market. On Monday, March 9, oil prices fell 25% for the day. This occurred just as the effects of the newly named COVID-19 virus were beginning to hit the global economy.[4]

4. **March-April 2020** – **Demand Destruction** – In response to the COVID-19 pandemic, governments issued stay-at-home orders, resulting in a precipitous drop in global economic activity. Air and much of ground transportation ground to a halt, bringing the global economy to a virtual standstill, the result of which was an unparalleled fall in oil demand, declining more than 20 million barrels per day for April.[5] In comparison, demand only declined by 1.3 million barrels per day in 2008.[6] Through April, oil prices reached new lows, falling to levels not seen since the late 1990s. While OPEC reversed course in early April with an agreement to cut production, it was viewed by the market as "too little too late" and insufficient to offset the decline in demand.

**WORLD OIL DEMAND PLUMMETS**




*Data source: Energy Intelligence, Bloomberg, L.P.; Data as of April 2020.*

5. **April 21, 2020** – **The Crash** – A combination of technical factors (futures expiration) and broad-based concerns over a shortage of global oil storage capacity resulted in oil prices closing at negative $37/barrel; the first time in history that prices fell below zero. In response to the demand destruction and limited storage availability, producers began shutting in production. As of late April, oil was trading in "super contango," meaning longer-dated futures contracts trade at a significant premium to the front-month contract.[7]

6. **May 2020** – **Recovery** – For the month of May, oil prices rose an astounding 88%, the biggest one-month gain on record. As of this writing, oil was trading in the high-$30/barrel range, up from $20/barrel at the end of March and $18.84 at the end of April.[8] The broad energy sector has seen a resurgence since March, as expectations for a recovery in demand due to economies re-opening has pushed prices higher. Publicly traded energy stocks, as measured by the return of the S&P 500 Energy Sector are up over 32% for the second quarter, outpacing all other major sectors. Midstream energy companies, as measured by the Alerian MLP Index, are up approximately 63% for the second quarter as of the end of May, having more than doubled from their March lows.[9]

## THE ROAD AHEAD: IMPLICATIONS FOR INVESTORS

With the energy markets in truly uncharted territory, the current outlook is marked by more questions than answers. Chief among these is when will short- and long-term demand recover—a question contingent upon some measure of resolution of the pandemic. There are scenarios in which future oil demand normalizes or increases (resulting in higher prices) and others in which demand is permanently lower. For example, pandemic-driven fears leading to less air travel and more working from home with less commuting would reduce demand. Alternatively, less use of mass transit resulting in more passenger cars (and less fuel-efficient vehicles) on the road may increase demand. Other questions abound, such as the potential impact of the adoption of electric vehicles and a possible demographic shift away from dense cities to areas with more open spaces.

Answers to these questions will come incrementally over the next few quarters. The implications for investors are potentially far reaching—as the largest oil producer in the world, this drop in demand impacts the U.S. in ways that weren't true a decade ago. What follows is a detailed examination of these impacts and how they could potentially play out in the near and long term.

**Private Energy**

- The greatest near-term impact for investors will be markdowns in value in private energy funds in which they have invested over the past five years. Results for the first quarter of 2020 are showing write-downs in the range of 10-35%, reflecting declines in commodity prices and distress in the energy sector. The magnitude of the declines varies by fund, with commodity price mix, hedging, and leverage being the key factors influencing returns. Some assets/companies will be permanently impaired, while others will have the financial stability to ride out the downturn.
- Expect consolidation and restructuring among private energy firms as the focus moves to managing distressed portfolio companies in existing funds. Many investors are justifiably discontented with private energy returns and may not commit additional capital today. Therefore, fundraising for private energy will be limited for the foreseeable future. Firms that are unable to raise new capital may find themselves in a long-term holding pattern, managing their existing assets with fewer personnel.
- Longer term, fewer funds and managers in private energy with less capital may create a more favorable environment compared to the previous decade in which the industry became overcapitalized. Ironically, the improved opportunity set in energy is coinciding with investors moving out of the sector. Additionally, unlike the previous decade, private energy funds (equity and debt) could have a diminished role as a source of capital for the energy sector.

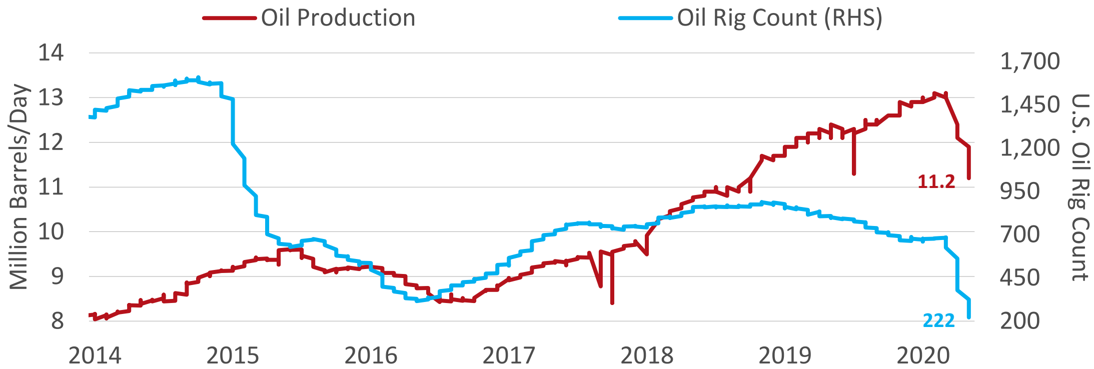
**Industry Response**

The response by the upstream energy sector has been aggressive. Driven in part by record low prices and serious concern about diminishing oil storage capacity that materialized in April, the industry has moved to shut-in production, and new drilling—as indicated by oil rig count—has diminished significantly. Record-low prices are finally forcing industry players to take steps that could begin to bring oil supply and demand into balance. In essence, the industry is responding exactly as it should in order to stabilize the market.

RIG DECLINE

The falling rig count indicates that future oil production in the U.S. will be lower in the intermediate term. The U.S. oil rig count is falling at the fastest rate on record. From mid-March, the rig count was cut in half in just over six weeks and is now down 65% since that date. For the last week of May, Baker Hughes reported the oil rig count declined 15 to 222, the lowest level in over a decade. This compared to 800 active rigs at the same time last year and approximately 1,600 at the peak in 2014. The oil-rig count has now fallen for 11 weeks in a row, suggesting further declines in domestic crude output.[10]

**FASTEST OIL RIG COUNT DECLINE ON RECORD**




*Data source: U.S. DOE, EIA, Baker Hughes, Bloomberg, L.P.; Data as of 5/29/2020*

SHUT-INS

According to HIS Markit analysis, the second quarter of 2020 is expected to see the largest volume of oil production cuts—including production shut-ins—in the history of the oil industry. Globally, as much as 14 million barrels/day of crude oil production is expected to be cut or shut-in between April and June 2020.[11] A rapid adjustment of global oil supply to a lower level of demand is taking place across the industry. As shown in the rig count chart, U.S. oil production has already fallen by nearly two million barrels per day as of the end of May. Nevertheless, analysts estimate more cuts in production and more shut-ins will be needed to rebalance the market.[12] One concern is how much production will realistically come back online, as wells often produce at lower rates after shut-ins.

**A Scenario for Higher Prices?**

The industry response is leading some observers to project continued growth in oil prices and possibly even a supply shortage in the intermediate term, which would have been unthinkable only two months ago.

- The oil industry requires ongoing investment to maintain production—even without demand growth—because wells have natural declines in production over time. Current industry dynamics are such that production will slow and could be materially affected by shut-ins and lower capex in the next 2-3 years. According to *The Wall Street Journal*, shale-oil companies have sharply reduced their drilling budgets for the year, with the top 15 by market capitalization slashing spending by an average of nearly 50%.[13] As U.S. output falls due to companies drilling fewer wells, there could be a supply shortage when demand recovers.

- Even continued investments into existing fields without any new fields being brought online—known as the "observed decline"—would still lead to a significant decline. Assuming global oil demand falls by 10 mb/d in the post-COVID-19 era, that would still leave a huge supply-demand gap. Finally, shut-in wells are not guaranteed to come back online at their previous levels of production, which could also contribute to constrained supplies.[14] While still uncertain, these factors could lead to prices rising sharply over the next 12 months if curtailed production does not come back online.

**Other Energy Dynamics**

NATURAL GAS

Sentiment around natural gas has shifted to a more positive outlook as U.S. oil producers announce production cuts and shut-ins that are expected to slow growth in U.S. "associated gas" production—i.e., natural gas produced as a result of oil drilling. Associated gas production has been a key factor weighing on prices for several years.

RENEWABLES/CLEAN ENERGY

In 2019, there were 2.2 million electric vehicles sold, but the research firm Wood Mackenzie expects just 1.3 million to be sold in 2020—a decline of 43%—due to the pandemic and its financial impacts. Therefore, lower oil prices, along with the decline in economic activity, are predicted to impact this segment of the clean energy market.[15]

## CONCLUSION

During the first half of 2020, there were weeks in which it felt like a decade of events were unfolding in the energy sector. We have previously outlined the headwinds facing the energy sector and noted a path to recovery as the industry continued to move toward greater financial discipline. The events of the first half of 2020 may represent both the final and necessary "washout" for the energy sector, as well as the turning point toward a more stable future. The most severe period of demand destruction may have passed, but challenges remain. After a prolonged period of misallocation of capital accompanied by a loss of confidence from investors, the energy industry may be moving into an era of better returns.

**FOOTNOTES:**

[1]Energy Information Administration, March 31, 2020 www.eia.gov

[2]Garcia, Luis. "Energy Company Southland Royalty Files For Bankruptcy", The Wall Street Journal, January 27, 2020

[3]Energy Information Administration, February 29, 2020 www.eia.gov

[4]Zhdannikov, Dmitry "Oil prices plunge by a third as rivals Saudi and Russia turn on the taps", CNBC March 9, 2020 www.cnbc.com

[5]Energy Information Administration, April 30, 2020 www.eia.gov

[6]The Sixth Disruption: The Impact of Coronavirus on the Oil and Gas Industry. Lime Rock Partners, May 2020

[7]Hodari, David "Oil Prices Skid, With May Contract in Negative Territory", The Wall Street Journal, April 20, 2020

[8]Energy Information Administration, May 31, 2020 www.eia.gov

[9]Standard & Poors and Alerian, May 31, 2020

[10]Baker Hughes, May 29, 2020 www.bhge.com

[11,12] Oil & Gas Journal, "Global oil production shut-in in Q2 to be largest in history" May 8, 2020

[13]Eaton, Collin, "Coronavirus Threatens to Hobble the U.S. Shale-Oil Boom for Years," The Wall Street Journal, May 24, 2020

[14]Kimani, Alex, "Oil Markets Could Soon Face A Devastating Supply Crunch" OilPrice.com, May 27, 2020

[15]Wood Mackenzie "Global electric vehicle sales to drop 43% in 2020", April 8, 2020