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Top questions from investors during the volatile market environment

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Do you see the oil price war ending anytime soon?
The focus appears to have shifted towards market share versus market price and sub-$40 oil doesn't work for anyone, not Russia, not Saudi Arabia and not the U.S. Most OPEC countries, including Saudi Arabia, are operating in a fiscal deficit and cannot afford to have oil prices in the $20-$30 range for an extended period of time. While the Saudis have the vast amount of world's oil reserves and a very low cost curve, the country will have difficulty funding its social budget at these lower prices. According to Reuters, Saudi's cash reserves were $490 billion at the end of 2019 down from $714 billion in 2014. Current oil prices would reduce Saudi cash reserves by $50 - $100 billion per year. The average breakeven price for OPEC oil producers is $80 per barrel, including Saudi Arabia. Russia's reported fiscal breakeven is $42 per barrel.

In our view, OPEC is likely not to reverse the last four years of hard work to reduce global crude oil inventories. For U.S. producers, we expect accelerated capital discipline starting with reducing drilling rigs. U.S. oil production likely declines if low prices persist. During the last oil price decline, U.S. oil production declined by 1.1 million barrels peak-to-trough. However, the pullback in crude oil could be positive for natural gas. Oil wells have been producing associated natural gas, which has grown in recent years. With less drilling for oil, associated natural gas should decline, leading to less oversupply and higher natural gas prices. It appears that Russia wants the U.S. to participate in production cuts and if the U.S. shows production declines, we think Russia will return to the negotiating table. In the long term, the world will need higher U.S., Russia and Saudi Arabia oil production to meet global demand.

How could a prolonged lower commodity price impact refinancing and repricing for existing contracts and fees?
Midstream energy companies are generally investment grade, so refinancing is not typically a midstream issue. There may be some high yield producers that will be watched closely, but there should not be a material impact on volumes or revenues for midstream.

Re-contracting existing pipelines will be dependent on the volumes, which will vary basin to basin. One positive to note is that there is some exploration and production company hedging in place for the current year which may help shield volume declines in the interim. Beyond these hedges, production will vary by basin. We expect Permian basin production to be more resilient while second tier basins, (Scoop/Stack for example), may be susceptible to production declines and ultimately less pipeline volumes. We believe the large-cap, high quality names that we own should have more resilient volumes due to their integrated value chains.

What are your thoughts on distribution coverage of midstream energy companies?
In our view, distribution coverage in aggregate is strong, but that is not necessarily true for every company. We have seen some distribution cuts recently and we could see more. It is possible that a company might consider cutting its dividend to do a share buyback or preserve capital.

How long does it take generally for a U.S. producer to shut down and then eventually start back up production?
Many producers actively hedge prices for their anticipated production for the year. So, a company may have hedged a significant amount of its anticipated 2020 production at levels closer to $60/barrel. As this is the case, we would not expect all activity to stop regardless of the price. It is also likely that many companies will keep a minimum level of activity to keep from losing their best crews.

Our investment team does not think there will likely be any material change in U.S. volumes until June, approximately a three month lag in volumes from lower prices today. This is based on the expectation that existing oil wells continue to flow, but fewer new wells are drilled/completed for some time going forward with spot prices this low.

When prices normalize at higher levels again, we will likely see a similar delay in volumes coming back on as crews have to be rehired or at least redeployed and the process ramps back up.

How long do producers typically hedge out their production?
Hedging strategies are different for every company. Typically, (but not always) the larger the company the less they hedge. Exxon, Chevron, etc. generally don't hedge at all while smaller, high yield companies tend to hedge fairly aggressively as they may need more certainty of cash flows to execute their strategy. Of those that are fairly aggressive hedgers, many use a strategy of layering hedges through the year. So, a company may currently be 50-80% hedged for 2020 and 10-30% hedged for 2021.

What percentage of midstream energy companies have counterparties that are investment grade? Of those that are non-investment grade, how many do you expect to experience difficulties?
Generally, midstream companies have counterparties that are about 60% investment grade, 10% high yield and 30% not published. If you assume the unpublished amount has the same split, that is 85% investment grade and 15% high yield. These numbers are approximate and relatively fluid and evolving with limited disclosure.

Of the high yield names, there will be some stress, but most still have liquidity through credit facilities and have debt maturities spread out over the next eight years or so. This gives them time to adjust budgets given the new price environment. We have spoken with many companies regarding this risk. They point to the fact that the producers, even in a bankruptcy, will be beholden to midstream companies to reach market and receive cash to pay debtholders. We have also heard that banks are not looking to take control of producers and will therefore be more lenient around covenants to avoid bankruptcies. For all of these reasons we continue to believe that there will be very little impact to midstream cash flows due to bankruptcies.

How have the energy debt securities performed?
Similar to energy equities, there is a large performance disparity between midstream debt securities and debt securities of the upstream's exploration and production companies. As of March 12, 2020, the Bloomberg Barclays High Yield Midstream Index returned -21% year-to-date, ahead of the broader Bloomberg Barclays U.S. Aggregate Credit - Corporate - High Yield Energy Index, which returned -32% for the same time-frame. The return of the broader index was dampened by the poor performance of high yield exploration and production companies. While there may be some more short-term pain, history suggests that strong intermediate-term, high yield credit can return from these levels.

We value the stability of midstream cash flows relative to other energy sectors, and in this distressed period, we believe that stability can result in much more defensive returns. Additionally, midstream companies now have lower leverage, higher coverage and are less commodity sensitive than they were a few years ago.

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