Gleneagles Conference Goes Virtual

Recap

SIMMONS ENERGY

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Participants

HALLIBURTON COMPANY (HAL) FIRESIDE DISCUSSION

Lance Loeffler
EVP & CFO

EOG RESOURCES, INC. (EOG) FIRESIDE DISCUSSION

Ezra Yacob
EVP, Exploration & Production

THE NEXT FRONTIER FOR GROWTH? OUTLOOK FOR RENEWABLE DIESEL AND BIOFUELS PANEL

Richard Voliva
CFO
HollyFrontier Corporation (HFC)

CJ Warner
President & CEO
Renewable Energy Group, Inc. (REGI)

BAKER HUGHES COMPANY (BKR) FIRESIDE DISCUSSION

Brian Worrell
CFO

PRIVATE EQUITY PANEL

Doug Swanson
Managing Partner
EnCap Investments L.P.

Bill Montgomery
Partner
Quantum Energy Partners, LLC |

TECHNIPFMC PLC (FTI) FIRESIDE DISCUSSION

Maryann Mannen
EVP & CFO

ENTERPRISE PRODUCTS PARTNERS, L.P. (EPD) FIRESIDE DISCUSSION

Chris Nelly
EVP, Finance, Sustainability & Treasurer

CNX RESOURCES CORPORATION (CNX) FIRESIDE DISCUSSION

Nicholas Deluliis
President & CEO

Chad Griffith
COO

Tyler Lewis
VP, IR

PHILLIPS 66 (PSX) FIRESIDE DISCUSSION

Kevin Mitchell
CFO

HELMERICH & PAYNE, INC. (HP) FIRESIDE DISCUSSION

Mark Smith
SVP & CFO

HAYNES AND BOONE, LLP RESTRUCTURING FIRESIDE DISCUSSION

Buddy Clark
Partner & Co-Chair, Energy Practice Group

WPX ENERGY, INC. (WPX) FIRESIDE DISCUSSION

Richard Muncrief
Chairman & CEO

CONOCOPHILLIPS (COP) FIRESIDE DISCUSSION

Matt Fox
EVP & COO

HESS CORPORATION (HES) FIRESIDE DISCUSSION

Greg Hill
President & COO

NATIONAL OILWELL VARCO, INC. (NOV) FIRESIDE DISCUSSION

Jose Bayardo
SVP & CFO

ENERGY LENDER PANEL

Randy Peterson
EVP & Group Manager Midstream Lending
Cadence Bancorporation (CADE)

Steve Kennedy
EVP & Head of Energy Lending
Zions Bancorporation, N.A. (ZION)

CONCHO RESOURCES INC. (CXO) FIRESIDE DISCUSSION

Will Giraud
EVP & COO

PLAINS ALL AMERICAN PIPELINE, L.P. (PAA) FIRESIDE DISCUSSION

Jeremy Goebel
EVP, Commercial

COMSTOCK RESOURCES, INC. (CRK) FIRESIDE DISCUSSION

Jay Allison
Chairman & CEO

Roland Burns
President & CFO

Conclusion

Our Gleneagles virtual conference reinforced the reality of an industry under duress, undergoing a radical right-sizing and concurrently pursuing a semblance of reinvention. As long time Simmons Energy analyst Bill Herbert observed, the energy industry is the most defensively positioned he has witnessed in his career. Overall, the energy sector appears to be in a prolonged workout and restructuring mode with the L-48 no longer driving the energy narrative, but rather responding to it. At some point, a cyclical opportunity is looming based on the convergence of austerity with demand normalization, but it is not an immediate likelihood. This being said, the austerity narrative conveyed by our industry participants isn't simply confined to L-48, as it is a global one. And, moreover, the adjustment underway is a radical retrenchment, with profound recalibrations taking place across the cost-curve spectrum, from Saudi Arabia, to L-48, to VZ. No one is immune.

At some point, the diminished deliverability of the industry will very likely have difficulty responding to a broad-based and durable reflation. While this, in all likelihood, isn't an immediate outcome, nor is it an endlessly distant one either. What follows in this note are our sector thoughts and key takeaways following the conference. As always, we want to thank the companies and investors for their participation. The event would not be possible without their support.

Energy Sector Thoughts Following the Conference

What strikes us about energy and was reaffirmed at our conference:

1. This is a severely disrupted industry, even beyond the secular challenges of renewables and ESG stigmatization. Yes while a vaccine and increasingly cyclical normalization will likely unfold in 2021, the demand element of oil is unlikely to fully normalize until 2023-2024 and perhaps beyond - not just due to Covid but also to the fact that this pandemic has pulled forward the future, and we are now far more comfortable living in a Zoom world and this impacts commuting and air travel.
2. Given #1, the global energy business, and especially L-48 is structurally overcapitalized and the industry needs to shrink in order to grow. Majors are frantically trying to sell refineries and the L-48 energy value chain is in the process of responding to a meaningfully redefined market opportunity requiring a multi-year rationalization and consolidation wave.
3. Given #2, austerity is the dominant theme of the industry, requiring a radical shrinking of reinvestment, a Darwinian right-sizing and acute focus on balance sheet management.
4. It is clear why energy is now the smallest sector in the SPX. For many investors, energy is in the "too hard" pile. In addition, other cyclical sectors have cleaner and more compelling stories and as the economy recovers, those sectors will likely be off to the races long before energy. It was noteworthy that a best-in-class energy PE leader at our conference stated that he would not be overweight energy as an asset class. He did state that the bright spot on the horizon is where these upstream businesses are restructuring to only have to invest 60-70% of their cash flow to maintain their business, which should result in blossoming and more durable free cash flow.
5. At some point a cyclical opportunity and L-48 reinvestment cycle should occur, but it is not on the immediate horizon. In addition, as L-48 wanes, the world will be increasingly relying on insecure sources of supply which at some point could drive energy security to the front burner. *Note continues on the next page*

Pearce Hammond, CFA
Sr. Research Analyst
Piper Sandler & Co.
713 546-9515
pearce.hammond@simmonspsc.com

Bill Herbert
Sr. Research Analyst
Piper Sandler & Co.
713 546-7203
william.herbert@simmonspsc.com

Ryan M. Todd
Sr. Research Analyst
Piper Sandler & Co.
212 284-5037
ryan.todd@simmonspsc.com

Ian Macpherson
Sr. Research Analyst
Piper Sandler & Co.
713 546-7287
ian.macpherson@simmonspsc.com

Mark A. Lear, CFA
Sr. Research Analyst
Piper Sandler & Co.
212 284-9324
mark.lear@simmonspsc.com

Kashy Harrison
Sr. Research Analyst
Piper Sandler & Co.
713 546-7330
kashy.harrison@simmonspsc.com

Related Companies:	Share Price:
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ZION	33.68
COP	35.86
CXO	50.65
EOG	43.14
FTI	7.81
HAL	15.99
HFC	22.82
HP	16.02
NOV	12.15
PAA	7.13
PSX	58.98
REGI	39.35

INDUSTRY RISKS

The primary risks for the energy business are: weak global economic activity resulting in depressed demand for oil and natural gas, increased supply of oil and natural gas and weak capital markets (especially given the capital intensive nature of the energy business).

Overall, the message from the conference was not hopeless despair, but rather that this is going to be a long haul on fixing the industry. For equity investors, they should continue to focus their attention on the best-of-breed companies with solid balance sheets, FCF potential and the ability to emerge a winner when the cycle eventually turns. For our latest thoughts on the energy sector, please see the most recent Energy Ruminations note.

Key Takeaways from the Conference

L-48 Redefined: The L-48 market has been redefined with expectations on forward drilling and completion crew utilization at half of what it was pre-C19. L-48 is unlikely to reclaim the exalted status of yesteryear anytime soon. As HAL stated, the NAM market will be smaller in terms of overall spending, its contribution to the global supply stack will be structurally diminished and international will gain share. Overall, the OFS industry is likely to witness a non-trivial rationalization and consolidation wave. Coming out of this, the industry will be smaller and more efficient. Regarding E&Ps, they are mostly in maintenance mode (keeping production flat) while focusing on balance sheet management and trying to generate FCF. Below are some pertinent company-specific perspectives on the L-48:

- HAL: Agrees that ~200-250 frac fleets is a reasonable mid-cycle activity target vs. prior peak of 450-475 fleets. Believes that 30% of the frac fleet is facing imminent attrition so nameplate capacity is likely closer to 300 fleets. This distills into a required utilization threshold of 225 working fleets required to drive pricing gains. Incrementals should be decent given the combo of cost out, cost absorption and, eventually, pricing gains.

- HP: Takes no exception with a 500-600 rig framework for 2022, but is comfortable planning the business for something below that. While HP is noncommittal on the timing of a bottom/inflection, the relatively consolidated competitive structure of the land drilling space (combined with increasing digitalization and cost structure reform) should support trough margins in ’21-’22 as in ’16-’17.

- NOV: Wellbore Technologies, which has historically been the locus of the company’s NAM presence, is engaged in a massive right-sizing and based on the assertive cost-out initiatives trough EBITDA vs. 2016 has been quite a bit better as a result. NOV believes that the NAM onshore has been redefined and will be structurally smaller relative to the halcyon days of yesteryear. While NOV has observed that there are some fearless entrepreneurs acquiring discarded assets for pennies on the dollar, they are the exception as opposed to the rule given the penal cost of capital burdening most of the industry.

- EOG: While the message coming out of Q2 earnings felt like a company that was gearing up for growth in 2021 given robust FCF at the strip, the message at our conference stressed more budgeting based on a conservative price deck and getting back to a maintenance level of activity in late 2021. Stated that “we are committed not to grow oil into a market that doesn’t want it.”

- CXO: Continues to message that 2021 is likely to encompass a maintenance program as it awaits a stronger signal from the market to return to growth. Will focus on FCF generation and debt reduction.

- PAA: Its expectation is that Permian oil production will be flat from current levels through 1H’21, which is slightly lower than our expectations.

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International—Better But Not Great: Overall, the international market is better than L-48, but on an absolute basis remains weak. Below are some relevant international data points from the conference:

- HAL: Will not sacrifice pricing for utilization internationally—the game has changed and the resolve on the part of the industry leadership to maintain pricing discipline has never been higher. Expects international in 2021 to be a mirror image of 2020. Seasonal weakness in Q1 and sequentially improving thereafter—2021 flat to up y/y.

- BKR: Envisions international activity troughing in Q1 and treading water until 2H’21.

- NOV: International has actually been holding up relatively well even though overall activity is at the lowest level since 2003. While customers are currently in a defensive bunker, the quest for more efficient kit and technology is an ongoing secular trend to NOV’s benefit. Moreover, the international OFS industry is becoming more fragmented, which is to NOV’s benefit. Notwithstanding, customers are hunkered down playing defense.

- FTI: ~75 trees have been awarded YTD, industry-wide, and 2020 likely results in 100 trees being awarded. Based on current visibility, FTI believes 150 trees will be awarded next year vs. what used to be a ~300-450 trees annual opportunity.

Source: Energy - Unrelenting Industry Headwinds Persist/Key Takeaways from Gleneagles Conference - September 7, 2020

Slow to Start an Overdue Consolidation Wave: Energy companies understand the necessity of consolidation (something that will become even more apparent as the energy transition unfolds in the years ahead), but there is a lack of willpower to jumpstart the process either as a buyer (i.e., worried that you will get your teeth kicked in by the equity market if you make an acquisition) or as a seller (i.e., reluctance to sell at these levels as well as cultural and management incentive issues). While investors hope a consolidation wave is ahead, commentary from our conference was more subdued on this front. Bottom Line: a long overdue, comprehensive industry consolidation remains more aspirational than reality. One PE panelist at the conference stated that activism is more likely than not in the upstream sector due to the need for consolidation, but activism would be driven by the reluctance of some upstream management teams to give up the C-suite. Two examples regarding this fitful start to a consolidation wave were provided by CXO and COP. For CXO, while the company has historically been an active consolidator in the Permian and sees the need for further consolidation, it does not see itself being a buyer in the current environment. For COP, consolidation is a good thing and needs to happen. Positive to see low-premium deals get done, but doesn't believe that these deals have been on high-quality or low cost assets. In addition, COP does not see valuations as particularly cheap for premium assets.

Higher Cost of Capital: Capital availability for the oil and gas sector continues to be limited. The resulting higher cost of capital will have positive ramifications for production discipline leading eventually to tightening supply/demand balances. Energy lenders and private equity participants at the conference both highlighted the difficulty L-48 upstream has in securing funding. The bank lenders at the conference (CADE and ZION) stated that Fall bank redeterminations would likely be flat-to-lower due to hedges rolling off, despite better strip prices. Both banks are being conservative as it relates to new energy loans and that they are able to get better covenants and loan pricing in most instances. Overall, these banks thought the current down cycle is worse than the previous down cycle in '15-'16, but that the banks were well positioned to deal with the losses. PE funds and capital markets are not willing to step up to support struggling companies. Sponsors are not taking as long-term a view as the bankers would have thought. Of note, one of the banks stated that there were several PE funds that they will not do business with in the future. OFS continues to be the most challenged sector, but the good news is that the banks have substantially reduced their exposure to OFS since the 2014-16 downturn.

Demand—Will Take Some Time to Reach Pre-Covid Baseline: PSX highlighted that gasoline and diesel demand are down ~10% y/y and have leveled off somewhat after an initial V-shaped PUD (pent-up demand) recovery. PSX has pushed their view of a recovery from 2H'20 to 1H'21. Gasoline and diesel are not expected to return to pre-C19 demand levels until 2H'21 and jet fuel not until 2024 (note: airline executives believe a return to normal is more in the 2024-25 time frame). While some might state that jet fuel is only 8% of global oil demand (pre-C19), that still represents 8 Mb/d of demand (pre-C19). Jet fuel demand is currently down 40-50% y/y. And, moreover, jet used to punch well above its weight in driving transportation demand growth, whereas today, and for the foreseeable future, it is punching well below.

Bankruptcy Lawyer's Perspective—This Downturn is Worse than the 1980s: Sobering commentary from an attorney at Haynes & Boone, which was has the largest number of bankruptcy lawyers in Texas. He believes that the current downturn for L-48 is worse than the one in the 1980s. Of note, in the 1980s energy companies did not have the complicated debt structures they do now. Important distinction: his assertion that the downturn could be worse than the 1980s pertained to the energy sector specifically and not necessarily to the state of TX. The downturn in the 1980s negatively impacted TX given the real estate and banking collapse, which is not occurring now. He believes 300 producers could file bankruptcy this year (240 had filed through August). On the OFS side, 221 had filed through last month. Keep in mind that these stats do not fully capture the state of despair in the OFS sector, given that many smaller Mom & Pop OFS companies choose to just shut down rather than file bankruptcy. Lastly, it seems PE is likely to invest in some bankrupt companies/assets.

Promising Renewable Diesel Outlook: HFC and REGI participated in an interesting panel regarding renewable diesel. From a very high level, the renewable diesel industry is very immature and early, similar to refining in the early 1900s with lots of progress and innovation to come. On the demand side, there are huge structural tailwinds that are likely underappreciated by the market, which instills a lot of confidence in capacity additions moving forward. Low Carbon Fuel Standards (LCFS) requirements drive 15%/yr growth in CA, 10%/yr in BC and 20%/yr in Oregon with plenty of momentum in WA, Canada as well as the Nordic countries. There is even some talk of a LCFS for the entire US. Carbon intensity is also driving a switch from ethanol to biodiesel/renewable diesel. Regarding refinery conversions, these decisions are driven by low carbon transition trends, BTC (bio-diesel tax credit) support and high rates of return on capital as well as the challenges of some existing refineries.

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