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Markit Commentary

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Leverage tightening the noose on US oil firms

Evaporating credit lines are set to finally squeeze US energy firms as oil prices break through $30 a barrel and US banks sound the alarm on rising bad loans in the sector.

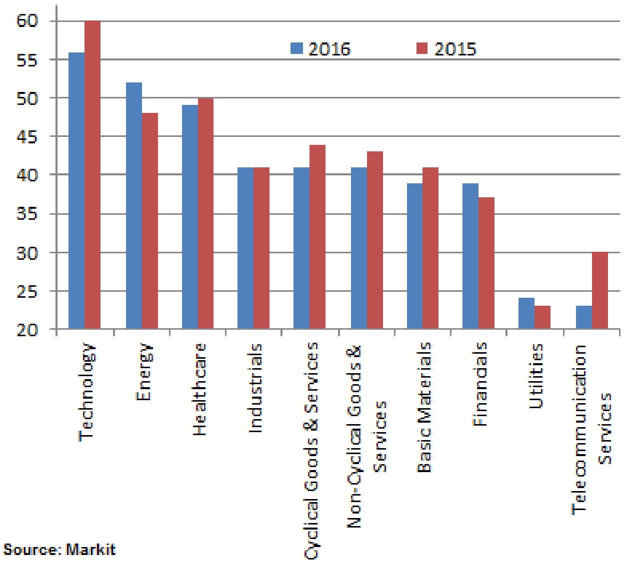
- US oil firms more levered than at the start of 2015 according to Markit Research Signals
- Geared energy names underperform peers by 24% over the last 12 months
- Shorts clamour for Chesapeake Energy as cost to borrow surges; third of shares sold short

Continued price declines

After the lifting of sanctions in Iran this week, expectations for increased oil output has put further pressure on oil prices with both Brent and West Texas Intermediate prices dropping to the lowest levels seen this century. In the US, embattled producers are finally being forced to consider **ceasing production** as banks reign in on credit lines for fear of rising bad debts.

Markit's **Research Signals Financial Leverage factor*,** show that US energy firms saw a degradation in their financial leverage position in the last 12 months as energy names saw their average rank rise over this timeframe. The sector's average ranking increased from 48 to 52 in the past 12 months – as declining earnings crimped the sector's ability to service its debts.

Average sector ranks:Financial Leverage



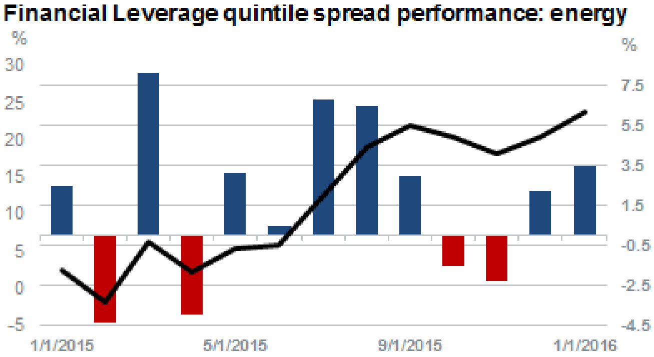
Source: Markit

The other two sectors that have showed a comparable increase in their leverage positions have been financials and utilities. In terms of absolute leverage, the technology sector still remains the most leveraged although it has witnessed a decline in leverage over the last 12 months.

Energy returns

This deterioration of the sector's overall leverage performance has provided opportunities to pick winners in the sector as the market actively avoided leveraged energy firms in the US versus their unleveraged peers. Investors, had they gone long the 20% least leveraged firms in the sector while shorting the 20% most leveraged would have earned 23.7% of cumulative returns over the past 12 months.

Financial Leverage quintile spread performance: energy

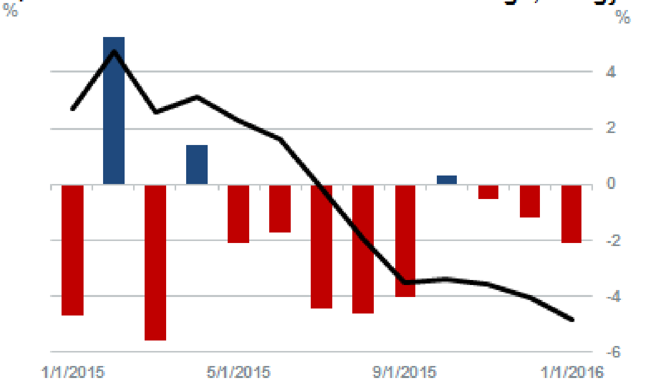


Source: Markit

Almost all the returns above have been delivered by the underperformance of fifth quintile firms – or the 20% of companies employing the most leverage which delivered returns of negative 24% over the last 12 months.

Ironically the leverage of the industry has been blamed on the increased production that occurs as oil prices drop. As firms aim to reach revenue targets, lower prices result in increased production levels to cover debt payments, creating vicious debt spirals.

Quintile 5 excess returns: Financial Leverage,Energy



Source: Markit

Short sellers target geared players

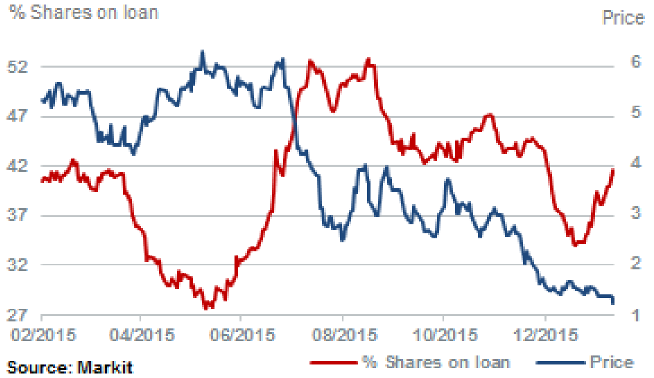
Investors have been voting with their cash over the last 12 months, with companies in the sector seeing the value of their equity plummet. Short sellers have also benefited by targeting energy names, but highly leveraged firms could add more returns to the shorts as oil producers are pushed to the brink.

Name	Ticker	Financial leverage rank	% Shares Outstanding On Loan	12 Month % Change
Rex Energy Corp	REXX	86	41.3	26%
Noble Corporation Plc	NE	10	35.2	118%
Atwood Oceanics Inc	ATW	33	35.0	1048%
Tidewater Inc	TDW	91	33.9	26%
Chesapeake Energy Corp	CHK	83	32.7	326%
Southwestern Energy Co	SWN	84	32.0	257%
Consol Energy Inc	CNX	92	28.4	769%
Northern Oil And Gas Inc	NOG	84	28.3	-7%
Basic Energy Services Inc	BAS	90	27.6	275%
Sm Energy Co	SM	22	27.2	581%

The average Financial Leverage rank across the top ten most shorted US energy names is 69, which is 50% higher than the universe average of 44 consisting of over 3000 single names.

Two specific names which have been the targets of sustained short selling in the past are Rex Energy and Chesapeake Energy with 41.3% and 32.7% of shares outstanding on loan and financial leverage ranks of 86 and 83 respectively (relatively highly leveraged).

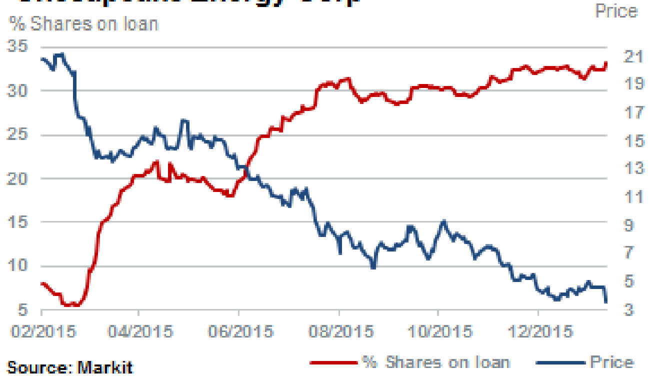
Rex Energy Corp



Source: Markit

Renewed oil price weakness has seen short sellers return to Rex Energy, increasing short positions by 15% since the start of the year, while the stock has fallen another 31%.

Chesapeake Energy Corp



Source: Markit

Short interest in Chesapeake remains at record highs with the demand to short the company surging as measured by the cost to borrow which is north of 20%, with 87% of available stock to lend utilised.

*The Financial Leverage factor is defined as the sum of the trailing 12-month pretax income and the trailing 12-month interest expense divided by the trailing 12-month pretax income.

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