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Subject: Buy Hess for levered oil upside

Date: Fri, 09 Sep 2016 19:04:13 +0000

Attachments: Global_Energy_Weekly_-_the_new_oil_bellweather.pdf; Oil_Inventory_Monitor.pdf; Hess.pdf; HES_2Q_recap.pdf

Inline-Images: image001.png

Jeffrey,

- Heading into the winter, we see oil prices picking up again and reiterate our 2016 year-end WTI target of \$54/bbl and mid-2017 WTI target of \$69
- We prefer energy stocks over WTI for a longer term view
 - CFTC positioning looks overbought and September tends to be seasonally weak
 - Equity fund managers are still underweight the energy sector, which should lend support
 - We expect a rotation from defensives into cyclical to further support energy equities
- **Hess** is one of our top energy picks. Stock pulled back recently on their Skipjack well failure but this has no read through to their other prospects. We see considerable upside potential in their Guyana Liza project (appraisal in 4Q16). In our view, the market is not sufficiently pricing in Guyana upside. Our price target is \$85 (70% upside from \$50.00 currently). Let me know if you'd like to do a deeper dive into our analysis.

Trade: buy \$2mm HES 8% 2/01/2019 at 62.50 (HES A Pfd)

- 6.4% strip yield, vs common stock at 2.0% div yield
- It converts with a low strike of \$39 (1.28 shares) and high strike of \$45.82 (1.09 shares) at maturity in 2019
- If stock is up 25%, the preferred returns 25.1%. If stock is up 50%, the preferred returns 46.9% (held to maturity)
- If stock is down 25%, the preferred returns -7.1%. If stock is down 50%, the preferred returns -32.7% (held to maturity)
- \$575mm notional, \$725mm market value outstanding (good liquidity)

We'll look to add names to Hess over time. Other top energy sector picks are DVN, CLR, MRO & COP.

[Additional market color following yesterday's energy short cover....](#)

Oil is down modestly, refusing to chase yesterday's short cover, as the market digests the outsized inventory draws, which may be a one-off due to the storm and ship channel issues. While crude is down 1.5% in early trading, the next two weeks will also be impacted by OPEC statements and press reports. One notable issue right now though is that CFTC positioning is bullish right now going into a seasonal lull for demand. Does this mean buying power will soon be exhausted for the commodity ??...Time will tell, but September and October are not without their downside risks. While weakness may be bought, it is worth noting storm normalizations coupled with seasonal pressures in the Fall may lead to a modest crude correction. On the positive side and as Doug Leggate notes in his weekly, demand cover for both gasoline and distillate is now back in line with last year - underpinning a modest recovery in refining margins. And lastly, as Francisco Blanch notes today he still sees a \$54 tgt for year-end WTI, followed by \$60+ in '17 (See Report below).

Yesterday was interesting with nearly 150bps of Energy sector outperformance vs the S&P 500 Index, led by what appeared to be a big wave of short covering where CHK, DO, APA, SWN, MUR were the top 5 performers in the S&P Energy and all having bigger than average short interests. Again, I have to draw from Doug's weekly (See

Attached), which sums it up pretty well. The impact of a one week significant crude draw has shown up with a strong sector rally across the board, but where lower risk names are now laggards vs higher beta names. In a rising oil environment, this will be the pattern in our view, led by a short squeeze in the early stages of a commodity recovery.

Conclusions.... We do not expect the recovery in oil prices to be a straight line. When overlaid with genuine improvements at the operating level, potential for outsize returns from higher beta names means the next 12 months will challenge stock selection with greatest opportunity for absolute upside lying within highest risk names. But there is middle ground where dislocations, portfolio rate of change and the potential for binary value recognition on longer dated assets all offer meaningful upside, without the need to accept lower portfolio quality or b/sheet risk.

Research Focus....

[Energy Weekly](#) Back in 1Q16 we warned that an oil recovery would not be a linear event and projected a pullback in WTI prices to \$39/bbl in 3Q16 on seasonal demand weakness (see [Look out for W in WTI](#)). Heading into the winter, we still see prices picking up steam again and reiterate our 2016 year-end WTI target of \$54/bbl. Thus, we continue to see any dip in prices as a buying opportunity, albeit with a couple of risks. (Francisco Blanch)

[Oil Inventory Biggest weekly oil draw since '99](#): imagine what happens if markets rebalance. Crude oil stocks dropped 14.5mmb, the largest since 1999 as a result of storms that impacted waterborne imports. Oil prices drove a strong sector rally but where lower risk names are now laggards vs higher beta names. In a rising commodity price environment, this will be the pattern, led by a short squeeze in the early stages of a recovery (Doug Leggate)

(This was prepared by a member of the Specialist Sales Team)

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