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Staying Energized in the Energy Downturn

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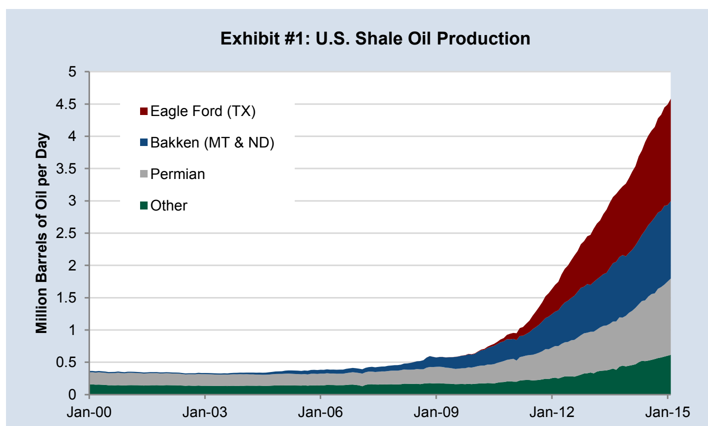
The 60% plunge in oil prices caught investors, analysts, and even industry participants by surprise. Unlike 2008/2009 when falling demand was the primary culprit, this time over supply is largely to blame, led by exponential growth in U.S. shale oil production, as shown in Exhibit #1. This surge was fueled by easy access to capital and low interest rates coming out of the Great Recession, and by improvements in productivity through innovations such as pad drilling and enhanced recovery techniques.



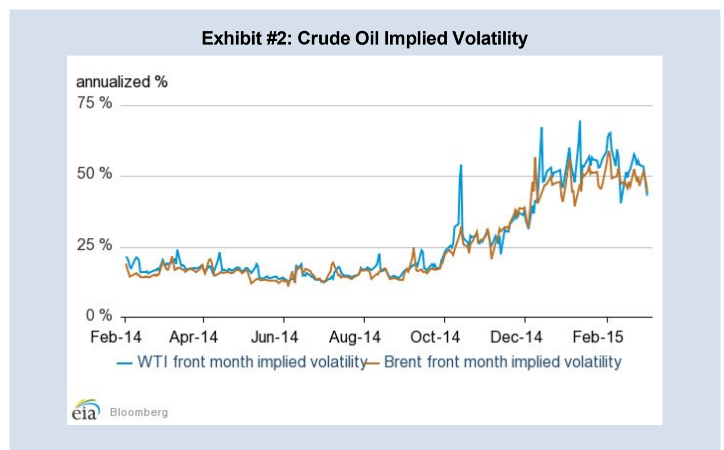
In addition to excess production from the U.S., production from Libya and Iraq surprised to the upside in 2014, generating an additional million barrels per day of supply.

In October, Saudi Arabia (followed by Iraq) cut prices of exports in an effort to preserve market share. Next OPEC (led by Saudi Arabia) refused to cut production quotas, to try to force U.S. shale players to cut production. Saudi Arabia was betting the U.S. producers, faced with higher extraction costs, would tap out first. In addition to these supply-related factors, slowing global demand and a stronger dollar also contributed to the collapse.

Producers have acted quickly and aggressively to cut back activity levels, as evidenced by the 44% fall in the rig count in just the past 15 weeks. Capital expenditure budgets for 2015 have been slashed in the range of 20-60%. Some companies have suspended share repurchase programs in an effort to conserve cash.

On the service side, prices are already coming down. Day rates are expected to fall 20-30% before stabilizing, with some customers demanding even greater reductions or breaking contracts altogether. The big four service companies have already announced layoffs of over 30,000 workers as they move aggressively to adjust for the decline in activity.

So where are oil prices headed from here? After sinking to $44/bbl in late January, and a dead cat bounce in February, the benchmark price of oil slid back into the mid-$40s. Projections from here are all over the map, from $20 bbl to $70 bbl. The implied volatility in crude oil futures has quadrupled over the last six months to the highest levels since the second quarter of 2009 as shown in Exhibit #2.



Given this backdrop, what types of companies are likely to withstand the low oil price environment and to emerge from the down-cycle in the best position? Key characteristics include:

Adequate cash flow: Companies that are able to finance all or the majority of investment with internally generated cash flows do not have to cut back so deeply in the downturn or worse yet, dump assets at fire sale prices, thereby hampering future growth. The key is to be able to maintain operating momentum through the downturn. Also, as asset valuations fall, not only will earnings be negatively impacted, but more importantly the amount of cash companies can borrow on credit lines will be slashed, as these are tied to the value of assets.

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Energized Energy

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Strong balance sheet: With the anticipated drop off in cash flow, many companies are having to either issue stock at low prices and higher dilution, or to take on more debt. Many of these same companies levered up before the downturn in their race to grow production at any cost. In contrast, companies with strong balance sheets have the ability to take advantage of sales of distressed assets or even whole companies, and are less likely to face large write downs resulting from aggressive expansion leading up to the collapse.

Reasonable Valuation: Valuation is a tricky element to assess in a downcycle given the wide disparity between trailing and forward metrics, particularly on earnings. So it is important to look at valuation in light of the full cycle and on a relative basis versus peers. Also, metrics such as enterprise value-to-reserves are useful to supplement income statement and cash-flow based measures.

From a portfolio construction perspective, it is important to recognize that sensitivity to changes in oil and gas prices varies greatly within the energy sector. Exhibit 3 shows the performance of selected sub-industries in relation to the price of oil from the summer peak to the present. Oilfield services and E&P companies experienced the steepest drop, while refining and marketing companies had the shallowest decline. These same dynamics occur in the recovery phase, as observed in the 2008-09 cycle in Exhibit 4.

Conclusion:

At Smith Group we are not in the business of predicting commodity prices. Our investment process is one of bottom up stock selection, with a focus on high quality, reasonably valued companies that are poised to exceed investor expectations. This strategy is more relevant than ever today in energy given the murkiness in the outlook for oil prices.