GRANT'S
INTEREST RATE OBSERVER®
Vol. 35, No. 05d | Two Wall Street, New York, New York 10005 • www.grantspub.com | MARCH 10, 2017

Laddered oil play

The plunge in oil prices to as little as $26 a barrel one year ago from as much as $107 in 2014 slowed exploration and drilling activity to a crawl. According to Simmons & Co., discoveries in 2015 were the lowest since 1952. Last year's are thought to be lower. Truly, low prices eventually fix low prices.

Oil is the subject, and bullish is the editorial predisposition. We write to propose a laddered approach to speculation on higher prices. But we interrupt ourselves to underscore the word "speculation." Some of the companies on the agenda are only barely profitable (or less) at current prices. Each is thus a leveraged play on higher prices, in some cases on much higher ones. Widows and orphans would be better off studying *The Daily Racing Form* than to encounter the tickers of these stocks on the printed page.

Besides, nothing says that the oil price has to go up, though we believe it will, with support both from the demand side and the supply side of the market. Certainly, nothing says that the price of oil must go up immediately. On Nov. 30, the Organization of the Petroleum Exporting Countries announced a reduction in output by 1.2 million barrels per day (mbpd) for six months beginning Jan. 1. It was a dull OPEC producer who did not realize that 31 days remained in which to fill every available receptacle with oil and put them on the water.

U.S. crude inventories therefore rose by 1.5 million on Feb. 24, to a record 520.2 million barrels. This compares to 486.7 million barrels on Feb. 26, 2016 and 356.4 million barrels on June 20, 2014, the date of the peak in the West Texas Intermediate (WTI) price. Reserves have grown, too, in regions of the world less carefully monitored.

Yet—even so—the population of oil bulls has ballooned. Since the OPEC announcement, speculative positions in crude futures have climbed by 83% to a net 525,254 contracts, near an all-time high. "We are worried about that record net long position as well," Jeff A. Dietert, managing director of Simmons & Co., tells colleague Evan Lorenz. "When everyone has already bought, who are the incremental buyers? It is a concern. . . . However, I would not be surprised to see $60 crude by midsummer, especially if OPEC decides to extend the cuts by another 6 months. I think that is the consensus view. I'm always nervous when my view is the consensus view. I'm much more comfortable when I have confidence in something that is unique or different."

"U.S. shale oil is unique," Lorenz points out. "A company can begin producing crude in as few as six months after committing capital on a well. Most big oil projects take five to eight years from discovery to begin producing. Major projects with an aggregate of just over 2 million barrels of production are poised to come online in 2017, according to the Simmons estimates. Between 2018 and 2021, major projects are slated to add only 1.1 million barrels of daily production each year, around half of the average they delivered between 2013 and 2017. It is this backdrop that starts a bullish analysis on oil and an appraisal of speculative oil-related securities."

Crucial is that demand is on the upswing. According to the U.S. Energy Information Administration (EIA), worldwide consumption of oil expanded by 1.7 mbpd to 98.6 million in the fourth quarter from 96.9 million in the fourth quarter of 2015. The EIA's February "Short-Term Energy Outlook" projects that this year's petroleum demand will exceed last year's.

Supply and demand can balance because supply goes up or demand goes down. Higher prices, by invigorating the search for oil, will cause more to be discovered and, finally, lifted. Recession in America or China could stunt demand. But—to take the cheery side of the short-term bearish scenario—lower prices and a still more depleted rate of E&P spending would likely lead to an even greater supply deficit over the horizon.

"I don't know if it is March or April, but we are going to see the imports from the Middle East decline, we are going to see refining utilization in the U.S. come back up post-seasonal maintenance, oil exports will continue to be high," says Dietert. "We anticipate that we will see crude inventories draw pretty hard, maybe in the second half of March, April and May. We argue that we should be drawing inventories globally about 600,000 barrels a day."

As for that worryingly large bullish position in oil futures, it has one bullish benefit. Because the oil price curve has flattened, it has become unprofitable to hoard oil in floating storage. Since the start of the year, the price difference between the front-month WTI contract and the contract three months out has collapsed to $1.21 from $2.33. For Brent crude, the difference has dropped to $0.52 from $1.62. In February, 6.8 million, 4.1 million and 1.2 million barrels of oil left tanker storage sitting in the waters of Malaysia, Singapore and Indonesia, respectively.

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Various oil plays become viable at different prices for oil. According to Kurt Hallead, the co-head of global energy research for RBC Capital Markets, the following rule of thumb typically (if only roughly) applies:

Saudi Arabia: $10
Permian Basin: $25–$35
Bakken Formation: $40–$50
International conventional land: $40–$50
Shallow water: $50-plus
Deep water: $60-plus
Oil sands: $75-plus
Arctic: $80-plus

Thus, at $52.79 per barrel, shale in the Permian Basin (extending from west Texas through southeast New Mexico) is deeply in the money. Exxon Mobil Corp., EOG Resources, Inc. and other shale producers have declared that they can earn double-digit returns even at $40 oil. They're drilling longer laterals (horizontally drilled well lines) and using more fluid and sand loadings to fracture the shale to extract more hydrocarbons per well site.

It's costing them more than it did at the bear-market depths. Simmons relates that U.S. E&P companies plan to boost spending by 60%-plus this year. To satisfy the resurgent demand, oil-service companies must rehire roughnecks and dust off idled equipment.

"We're seeing surging demand for sand proppant," U.S. Silica Holdings, Inc. CEO Bryan A. Shinn told dialers-in on that company's Feb. 23 earnings call. U.S. Silica and competitor Hi-Crush Partners LP expect to be operating at 100% of capacity by the second quarter. While both companies are investing in new capacity, they are also hiking up prices. Sand, a friend says, has become the "caviar" of fracking.

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"As oil rises from the low $50s, the Bakken Formation in North Dakota and Montana will move further into the money," Lorenz observes. "Compare Diamondback Energy, Inc., an E&P company focused on the Permian Basin, to Oasis Petroleum, Inc. (OAS on the NYSE), a Bakken producer. The two are of similar heft: In 2016, Oasis lifted an oil-equivalent of 50.4 thousand barrels per day, Diamondback an oil-equivalent of 43 thousand barrels per day. However, it cost Oasis $43.49 to lift oil out of the ground vs. $22.17 for Diamondback. Since the 2014 oil-price peak, the Oasis share price has declined by 74% to $14.21 per share. Over the same period, Diamondback has rallied by 16% to $104.58.

"The Street estimates that Oasis will generate net income of $34.6 million in 2017 or $0.15 per share," Lorenz goes on. "With 21 buys, 15 holds and one sell, analysts may be described as friendly toward the stock, if not head-over-heels bullish. Investors may be characterized as guarded—15% of Oasis's float is sold short—though the company has outstanding $300 million in convertible notes. People may be hedging.

"Oasis has operating leverage to every dollar increase (or decline) in the price of oil, and this operating leverage is further multiplied by financial leverage. As of Dec. 31, 2016, B-plus/B2-rated Oasis had debt, net of cash, of $2.3 billion. In the fourth quarter of 2016, Oasis generated an operating loss of $1.7 million vs. $34.9 million in interest expenses. The sustainability of the company's debt is a function of the oil price: In 2016, net debt footed to 4.8 times earnings before interest, taxes, depreciation and amortization (EBITDA); based on analyst expectations, net debt is 3.2 times 2017 EBITDA. Oasis does have time to wait for a higher oil price. The company faces no bond maturities in 2017 and 2018, and only $54.3 million worth of bonds matures in 2019."

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Oil in the $60s would refloat many a hope for the companies that fish for oil in the blackest depths of the ocean. The share prices of deep-sea drillers Transocean Ltd. and Atwood Oceanics, Inc. (RIG and ATW on the New York Stock Exchange) have declined by 72% and 82%, respectively, since the price of crude topped out (*Grant's*, March 11, 2016). Transocean operates a fleet of 56 mobile offshore drilling units, including 30 ultra-deep water units. The smaller Atwood manages 10 offshore units, including six suitable for ultra-deep work (there will be eight by 2018 if deliveries proceed as planned).

Transocean and Atwood had enough old business on their books to generate the operating income with which to cover interest expense in the fourth quarter by margins of 3.1 and 1.7, respectively. What happens as such profitable legacy contracts roll off is the question of the hour. Analysts expect no good news. For Transocean they have penciled in a net loss of $180 million in 2017 vs. a net profit of $782 million in 2016. They project that Atwood will lose $43 million in fiscal year 2017 (ends Sept. 30) from a net profit of $265 million in fiscal year 2016. Neither stock is winning any popularity contests—short interest amounts to 16% of Transocean's float and to 30.2% of Atwood's. Out of the 27 analysts who follow ATW, exactly two say "buy."

Both companies, then, are highly speculative plays on deep water coming into the money. Salvation would seem to depend on $60-per-barrel crude. Would any in posession of certain knowledge of when that price will be reached please contact this office to share?

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"Suncor Energy, Inc. (SU on the Toronto Stock Exchange)," Lorenz writes, "is a profitable oil refiner burdened with unprofitable oil sands and offshore exploration and production businesses. Suncor's oil-sands operations are focused in the Athabasca region of northeast Alberta while the company's offshore oil business drills off the coast of Canada, in the North Sea, and, prior to civil wars, off of Syria and Libya. Between 2013 and 2016, Suncor's pretax income fell to C$86 million ($64 million) from C$6.4 billion (with a 'B') owing to the collapse in oil-sands earnings (to negative C$1.6 billion from positive C$2.7 billion) and the offshore business (to negative C$15 million from C$2.3 billion).

"The refining business gives investment-grade Suncor an enviable stability (certainly, Transocean and Atwood must envy it)," Lorenz continues. "In the fourth quarter, operating income covered interest expense by three times. It can't be said that the equity-valuation metrics are as comely as credit ones. The stock trades at 152.9 times trailing earnings and 23 times the 2017 estimate—a return to profitability of the oil-sands operations would help."

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More, even, than Suncor, Nigeria would relish a higher price for its principal export. Not that $60 Brent would fix all the West African nation's problems, which encompass Boko Haram, famine, waterborne disease, an absentee president (where is Muhammadu Buhari?), kidnapping and airports closed on account of potholed runways.

However, a rally in crude oil would go a long way to cure such economic tribulations as recession (the first in 25 years struck last year) and the collapse of the Nigerian currency, the naira, which has fallen by 48%, to 315 to the dollar since 2014. The black market rate is over 500.

"Given the long list of problems," Lorenz points out, "you might expect to find commanding investment bargains. Yet, while the Nigerian Stock Exchange Main-Board Index has dropped by 68% in U.S. dollar terms, it still trades at 13 times trailing earnings. Even adjusting for the fact that earnings have declined by 33% between 2014 and 2016, the Nigerian Index is not cheap.

"There are, however, indirect ways to profit from a prospective turnaround in Nigeria," he goes on. "Copperbelt Energy Corp plc (CEC on the Lusaka Stock Exchange) is a Zambia-headquartered electrical generation, transmission and distribution company active in Sub-Saharan Africa. The stock has a market cap of kwacha 1.7 billion ($172.1 million).

"The company's main assets are a profitable business in Zambia and money-losing businesses in Nigeria. In the first half of 2016 (the most recently reported results), Copperbelt's Zambian operations posted an 11% year-over-year increase in EBITDA to $39.2 million, while the Nigerian operations generated negative EBITDA of $28.8 million (an improvement from the negative $53.1 million in EBITDA in the first half of 2015). The Zambian operations fund a 12.4% dividend yield, and the market assigns zero value to the Nigerian generation and distribution assets.

"Last November," Lorenz concludes, "Copperbelt obtained approval to peel off the Nigerian assets to shareholders as a separately listed company called CEC Africa. The final date of the spin-out has not yet been decided. 'If a spin-off is completed before the Nigerian problems are fixed, then shareholders will receive a security of an insolvent company,' says Francis Daniels, co-founder and director of Africa Opportunity Partners. 'After intervention by the Nigerian government, CEC Africa should be solvent. Therefore, CEC Africa is a free option on Nigeria developing a private-energy industry. It is the cheapest way to invest in the Nigerian industry.' So, buying Copperbelt today secures a high-dividend-yielding stock with an option on higher oil prices returning Nigeria to economic solvency."

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