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Not such fossils

Evan Lorenz writes:

World demand for oil will peak in 2029 before spiraling into permanent decline as electric vehicles replace gas-guzzlers, the International Energy Agency predicts. And come that great inflection point, the world's capacity to produce oil—swollen by hyper-productive U.S. shale wells—will exceed the global demand by no fewer than 8 million barrels a day. It would be the largest supply overhang since the depths of the Covid lockdowns.

In preview, *Grant's* is bullish on oilfield service firms Halliburton Co. (HAL) and Schlumberger N.V. (SLB, both on the New York Stock Exchange).

Granted, the second paragraph may not seem logically to follow the first, but the IEA's forecast forgets one thing. Yes, aggressive mandates, like the United Kingdom's requirement that 80% of new-car sales must be of the zero-emission variety by 2030, will nudge the world toward more EV production, but who will buy the confounded things?

Stellantis N.V., which manufacturers one out of every nine new vehicles sold in Britain, says the incentives needed to entice customers to adopt EVs at even this year's target are uneconomical. "The fact is that demand is not there," Maria Grazia Davino, Stellantis U.K. group managing director, told the press last week. The automaker is threatening to stop manufacturing vehicles of any type in the U.K.

Following Russia's 2022 invasion of Ukraine, West Texas Intermediate crude shot to $123.70 per barrel from the $75.21 prevailing just seven weeks earlier; natural gas at Henry Hub leapt to $9.68 per thousand cubic feet from $3.73 per mcf.

Responding to those prices, American energy companies employed 198 more drilling rigs by late 2022 than they had at the end of 2021. The result? New supply soon drove WTI back to $83.07 per barrel and natural gas to $2.47 per mcf (with a springtime pitstop at $1.58).

Energy companies reacted to this reaction by paring back drilling programs—they, too, read the newspapers—especially in gas plays. As of June 28, the rig count had sunk slightly below its pre-invasion levels. All of which suggests that, pace the IEA forecast, shale producers are unlikely to ignore price signals and to continue to add capacity in the face of weakening demand and falling prices.

Besides, the American oil patch is consolidating, with megadeals in the past 12 months including ExxonMobil Corp.'s acquisition of Pioneer Natural Resources Co. for $68 billion, Chevron Corp.'s purchase of Hess Corp. for $59 billion and Diamondback Energy, Inc.'s buy of Endeavor Energy Resources, L.P. for $26 billion. Combining their exploration programs, such companies will make do with fewer drilling rigs.

Smaller producers take a different approach to drilling than mega-sized companies do, Tom Loughrey, president of FLOW Partners, LLC, analysts of geologic and production data, reminds me. Catering to investors and creditors, companies like Pioneer showcase capital efficiency—"and generally that means a single period's finding and development costs"—rather than production volumes. To maximize capital efficiency, they drill widely spaced wells with long laterals. Such wells are gushers, but the gushing leaves barrels in the ground.

"We're confident we can recover an additional 1 billion oil-equivalent barrels, more than either Pioneer or the industry could have demonstrated with their existing performance," Exxon's senior vice president, Neil Chapman, told participants on an Oct. 27, 2023 earnings call shortly after the Pioneer acquisition was announced. The reason is tighter "well spacing."

Of course, as Loughrey notes, there are costs to this approach to resource extraction—e.g., lower initial production rates and slower rates of growth—as well as benefits, such as longer life for America's most important hydrocarbon basin. The Permian extends from West Texas through New Mexico and accounted for 74% of global oil growth between 2015 and 2022.

In the new edition of the Dallas Fed's quarterly energy survey, 55% of polled executives said that continued consolidation among producers will lead to declining production over the next five years. "The majors are not going to exhaust reserves to raise domestic production until supply and demand curves meet their goals," one respondent told the Dallas Fed. "They do not have to participate in treadmill drilling to keep incomes at a pace to develop reserves and pay back loans." They want higher prices.

There's something else. Energy demands tend to balloon as income increases. "You have 1.4 billion people [in the West] who maybe are flattening out in terms of their energy demand per capita, but you've got 2 billion people [in emerging markets] who are going to start the progression of moving up in terms of energy consumption," Robert Robotti, the eponym of Robotti & Co. Advisors, LLC, tells me. "We're going to need renewables, but the fact of the matter is that renewables can't be built fast enough to meet demands as the world's energy needs continue to grow."

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Halliburton is the world's third-largest oil-field services company by revenues, behind Schlumberger and Baker Hughes Co. "Completion and production" is the first of two SLB business units. Contributing 59% of revenues in the 12 months ended March 31, it encompasses cementing, artificial lift, intervention, pressure control and pipeline services. "Drilling and evaluation," which chips in the other 41% of sales, supplies field and reservoir modelling services, specialized software, drill bits and project management.

Despite operating in more than 70 countries, Halliburton depends on North America for 44% of trailing revenues. This domestic bias has been a drag on results. In the first three months of the year, HAL reported a 2.2% year-over-year uptick in revenues, attributable to an 11.9% expansion outside North America—and a 7.9% contraction within it.

The culprit is the decline in American drilling activity. Of course, the same American focus would prove a boon in case of a recovery in U.S. natural gas activity. Today, to be clear, there's a glut of gas, with inventories bulging at 18.4% above their five-year average.

"Over the next 18 months, [liquefied natural gas] exports will increase by 4 [billion cubic feet per day] as three new domestic projects come online," Goehring & Rozencwajg Associates, LLC advised its clients in May. "By mid-2027, an incremental five bcf/d of additional capacity is expected to come online, bringing total LNG exports to an incredible 20.4 bcf/d compared with less than 12 bcf/d today—the sharpest three-year growth in U.S. history." For a sense of scale, American production averaged 123.8 bcf/d in April.

Canada and Mexico, too, are ramping up LNG export capacity, while industrial consumption of cheap American gas is growing and power-hungry data centers are turbocharging the demand for electricity (*Grant's*, May 24). At a JPMorgan Chase & Co. conference last month, gas producer Range Resources Corp. estimated that U.S. demand could grow by 22 bcf/d by 2028.

Price calls the tune

source: The Bloomberg

"The total rig count has come down, but even more has come out of gas than has come out of oil," Roger Read, who rates HAL a buy and SLB a hold for Wells Fargo & Co., tells me. "One of the things we think happens is you're going to get a recovery on the gas rig count and a modest recovery or, at least, a plateauing on the oil side.

"As you transition to the end of 2024 and certainly into 2025, we expect you're going to see U.S. capex [on drilling] growing at a slightly higher rate," Read goes on. "And then, in 2026, we think there's a case to be made that U.S. capex will actually grow faster than the rest of the world."

Other factors support a bullish view on oil activity. To produce more while drilling less, energy companies have mined their backlog of drilled but uncompleted wells (DUCs). "After 12 straight months of DUC draws since March 2023, we've seen over the past two months a slight DUC build, despite a rig count that continues to decline," a team of Barclays Capital, Inc. analysts led by J. David Anderson pointed out last month. "Looking at the well-completed side of the DUC equation, we're beginning to see signals of a bottom forming. Point being, we're hovering around historical lows of the DUC count and therefore would expect a replenishing effort by [exploration and production companies] towards the later part of the year and into 2025, assuming a supportive commodity-price environment."

As of March 31, Halliburton's balance sheet showed a net debt balance of $5.7 billion or 1.1 times trailing Ebitda. In the first quarter, operating income covered interest expense by 10.7 times. Rated A3/triple-B-plus, Halliburton is an investment-grade borrower by the skin of its teeth.

A 22% downdraft from its peak share price last October notwithstanding, HAL has generated a 27.3% return since our bullish appraisal on Jan. 21, 2022, nearly matching the tech-heavy S&P 500's 30.2% rise (reinvested dividends included). Even so, Halliburton trades at just 10 times estimated 2024 earnings.

Management surpassed itself last year by returning 66% of free cash flow to shareholders in the form of dividends and buybacks, up from the 50% it had established as its target. On the April 23 earnings call, the front office guided for around $1 billion's worth of buybacks this year against a market cap of $30 billion. The shares are priced to yield 2%.

It must be said that the stock is better liked on Wall Street than in the Halliburton executive suites. While 24 of the 28 assigned analysts say buy (none says sell), corporate insiders have sold 738,854 shares over the past 12 months for proceeds of $27.3 million; 3% of the equity float is sold short.

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Schlumberger, the largest oil-field services firm, with $34.1 billion in revenues, divides its business into four operating units. The largest, well construction (39% of revenues in the 12 months ended March 31), comprises mud-logging services, drilling fluids, drill bits, cementing, well construction and drill rigs. Production systems (30%) spans artificial lift, valves, processing and treatment and a host of subsea services. Reservoir performance (20%) offers wireline services, well testing, stimulation and intervention services. The fourth and final segment, digital and integration (11%), purveys software, data processing and management for energy-field projects.

Schlumberger does business in more than 100 countries. The Middle East and Asia, which make up 34.3% of trailing sales, dwarfs operations in the United States, Canada and Mexico, which contributed 19.4% of the top line. So, in the first quarter—in inverse fashion from Halliburton—a 5.9% year-over-year decline in North American revenues could not negate a 12.6% gain in overall sales. Schlumberger is a citizen of the world.

"They have a leading presence in some of the fastest-growing geographies," Stephen Gengaro, who rates both HAL and SLB buys for Stifel Financial Corp., tells me. "They have a track record of being a leader from a technology perspective. That has led them to having higher margins than everybody else internationally. And they have more technology advancements than Halliburton in new energy," including carbon capture, green hydrogen, geothermal and lithium extraction, "that will allow them to play for the longer term."

Despite those well-acknowledged attributes, Schlumberger threw investors for a loop on April 2 by announcing the acquisition of ChampionX Corp. for $7.8 billion. ChampionX has leading positions in production chemicals (64% of first-quarter revenues) and artificial lift (27%), businesses that facilitate well production. Notably, such acquired business lines are much less cyclical than Schlumberger's core activity of drilling wells. Does the deal signal a downturn in exploration spending?

Not on your life, says management. "We're in the midst of a unique oil and gas cycle, characterized by strong market fundamentals, growing demand and an even deeper focus on energy security," Schlumberger CEO Olivier Le Peuch told dialers-in to the April 19 earnings call. "This cycle continues to display breadth, resilience and longevity. This is very much the case in the Asia region."

The new acquisition should rather be seen as a complement to Schlumberger's existing offerings. "Despite the largest international footprint in energy services, production chemicals represented one of the few holes in the SLB portfolio," to quote from an April 3 Barclays report. "ChampionX's Production Chemicals Technology segment should fit seamlessly into its Production Systems segment.... More importantly, this provides another additional revenue visibility for SLB through the end of the decade as production chemicals demand will likely steadily increase as new volumes from the Middle East and offshore come on stream along with growing demand to support aging existing oil fields."

On March 31, Schlumberger's balance sheet showed $9.5 billion in net debt, which corresponded to 1.1 times trailing Ebitda. In the first three months, operating income covered interest expense by 13 times; A2/single-A are the solid investment-grade debt ratings.

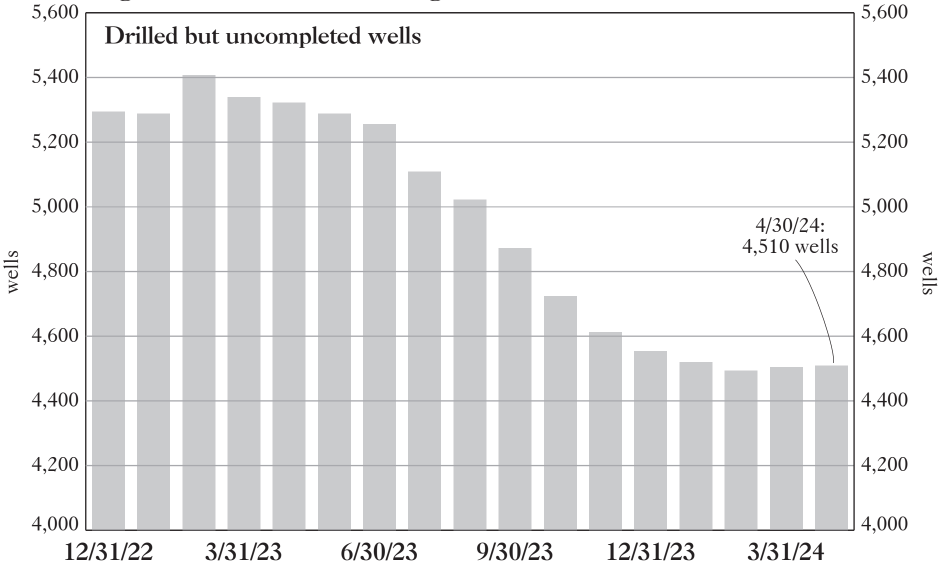
Following a 24.8% post-September swoon, Schlumberger's shares are priced at 13.2 times estimated 2024 earnings and to a 2.4% dividend yield. "The stock is trading at an EV [to next year's] Ebitda multiple of 7x, the lowest valuation in a non-crisis year since 2011–13," Benchmark Co. analyst Kurt Hallead observes. In the past, he adds, such valuation junctures have catalyzed bounce-back rallies.

After disclosing the ChampionX purchase, Schlumberger raised its 2024 share-buyback program and dividend payments to $3 billion from $2.5 billion and set a target to return $4 billion to shareholders in 2025. Pro forma the stock that will be issued as part of the acquisition, Schlumberger's market cap stands at $73 billion.

Wall Street loves SLB for its low valuation—30 buys and one expression of neutrality is the range of opinion of all analysts on the case—but the C-suite, like Halliburton's, appears guarded. Thus, over the past 12 months, insiders have sold 498,950 shares for proceeds of $26.2 million, while 2.2% of the float is sold short (some of which is attributable to merger-arbitrage strategies).

Of course, a global recession could

Sign of a bottom in drilling?



source: The Bloomberg

derail energy demand and therefore the demand for drilling services. However, Robotti warns, "the tightness in supply-demand today is unparalleled in history. In 1985, the world could produce 75 million barrels of oil per day and it consumed 55 million barrels of oil. There was a 20 million barrel excess the world had.

"Fast-forward to today," he continues, "and instead of consuming 55 million barrels a day, we consume 103.8 million. We could produce 106.7 million barrels a day. If something happened, and some place that produced 4 or 5 million barrels of oil went offline, where would you get the supply to fill that? Well, I don't know where that gap comes from."

More drilling, perhaps?

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