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Drill, baby, drill

Evan Lorenz writes:

To mitigate the consequences of a readjustment in Britain's natural-gas price caps next spring—which is to say, a 50% jump in prices—electricity provider SSE Energy Services has some free advice for its customers, for instance: "Cuddle with your pets," and keep the "oven door open after you've finished cooking." Not to be outdone in the cringe department, an SSE competitor, E.ON UK plc, is giving away socks bearing a cartoon of the sun embracing a grateful planet Earth. Not a word from the respective corporate PR staffs about eight years of worldwide underinvestment in oil and gas production, still less on the investment appeal of Halliburton Co. (HAL on the New York Stock Exchange), one of the world's major oil-services companies. As for the latter omission, we fill the gap below; in preview, *Grant's* is bullish.

Levitating energy prices have taken a special toll on Europe, where price controls, Russia's geopolitical gamesmanship, unseasonably weak winds and (in the case of France) untimely decommissioning of a handful of nuclear reactors have stunted energy production and pushed power suppliers from the UK to Italy and the Czech Republic into bankruptcy.

In such circumstances, you'd expect the well-worn truism about high prices to come into play. But high prices, this time around, are eliciting scant new supply, particularly of fossil fuels.

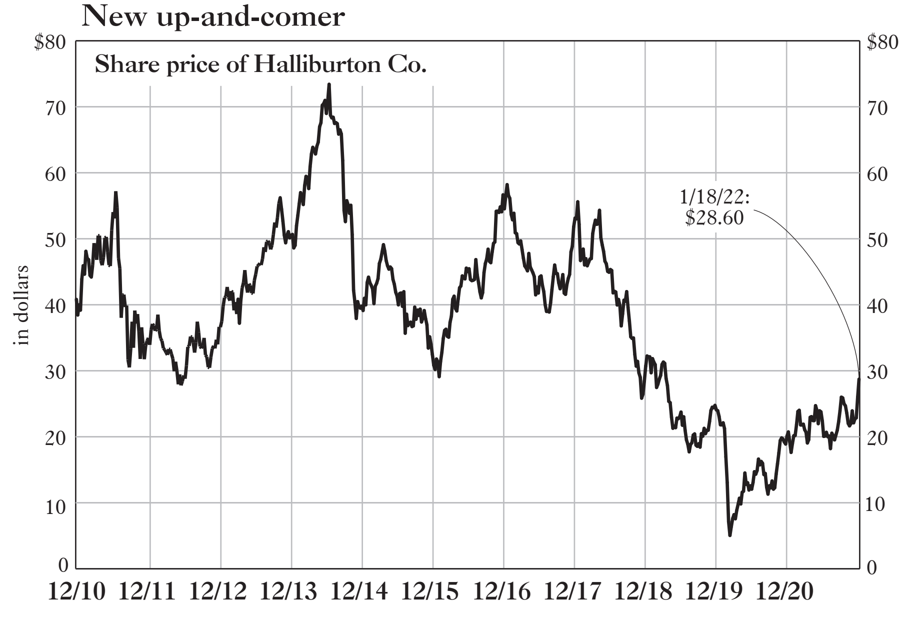
The essential bear case on Halliburton blares from the front page of just about every newspaper. The days of oil and gas, relics of climate ignorance, the headlines say, are numbered. Last year, 140 signatories of the Glasgow Climate Pact pledged to reach net-zero emissions by 2050. And last May, a Dutch court ordered Royal Dutch Shell plc to act sooner: to cut by 2030 its emissions by 45% from levels prevailing in 2019.

Not only governments but also institutional investors and corporate managements are pushing energy providers to decarbonize. In the UK, Ovo Energy (whose SSE subsidiary issued those helpful tips for staying warm) is aiming to reduce its own emissions to zero by 2030. And last week, Exxon Mobil Corp., née Standard Oil Company of New Jersey (John D. Rockefeller, CEO), dutifully announced its intention to sell its shale gas properties in Canada and in Ohio's Appalachian Basin.

Not surprisingly, some exploration and production companies are worried that newly drilled wells may become stranded, economically or legally, by environmental rules or carbon taxes. Nor do they forget the investment boom that culminated in the spectacular crash of 2014 and the subsequent series of boomlets and bustlets.

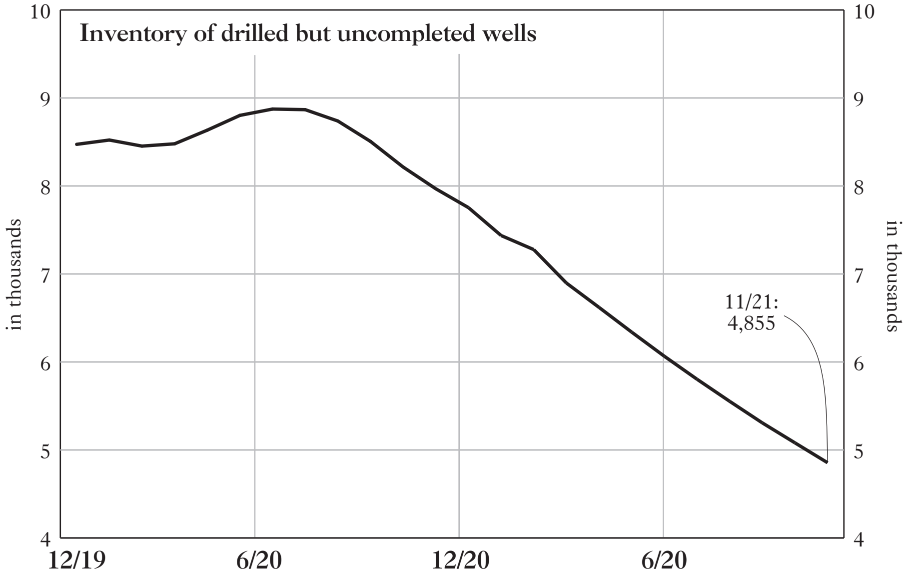
Which leaves the consensus of mainstream opinion projecting that the current tightness in energy markets will dissipate as the price of crude oil declines. "We forecast that global oil production will outpace global oil consumption during both 2022 and 2023, resulting in rising global oil inventories," opines the U.S. Energy Information Administration in its newly is-

New up-and-comer



source: The Bloomberg

Bottom of the barrel?



source: U.S. Energy Information Administration

sued "Short-Term Energy Outlook." "We expect global oil inventories will rise by an average of 0.5 million b/d in 2022 and by 0.6 million b/d in 2023 and that these inventory builds will generally put downward pressure on crude oil prices. Brent prices average $75/b in 2022 and $68/b in 2023 in our forecast"—compared with $88.11 per barrel today.

Grant's demurs. It strikes us that, even with environmental mandates, the demand for oil is likely to continue to grow for at least the rest of the decade. Bloomberg Finance L.P., concurring, expects that the oil demand for surface transportation will rise to 45.5 million to 46 million barrels per day by 2029–30, from around 43 mbpd today. For its part, the EIA predicts that the worldwide fleet of internal combustion engine–powered surface vehicles won't peak until 2038. Altogether, it sounds as if a synchronous, decades-long run for new oil wells is in the cards.

After incinerating cash for the past decade, humbled American shale companies are promising to invest within the parameters of their cash flow and to remit excess cash to the shareholders. The anomalous result is that, in stock market terms, American energy companies are running circles around their vendors. Thus, the Energy Select Sector SPDR Fund (XLE on the NYSE Arca), which is weighted to exploration and production, generated a 53.3% total return last year, while the VanEck Oil Services ETF (OIH, on the same exchange), which counts Schlumberger N.V. and Halliburton as its two biggest holdings, returned 21.3%.

"In a nascent energy bull market, the service guys should outperform—and I think they will eventually," Adam Rozencwajg, one half of the eponym Goehring & Rozencwajg Associates, LLC, a commodity-focused investment firm, advises by email. "Why aren't they? Normally at this stage in the cycle, higher prices would attract capital that would end up forming the service companies' revenue.

"This time, because of ESG," Rozencwajg goes on, "the oil price is sending the signal but the market mechanism cannot work its magic (yet another market that's not being allowed to clear!). As a result, this cycle will snap with much higher oil prices than I would have thought even eight months ago. A price of $150 is not out of the question. Eventually this will result in more activity and earnings leverage for the service providers, but perhaps it's a half-step later than in prior cycles."

Goehring & Rozencwajg acknowledge that oil consumption has periodically surpassed oil production—it's how oil stocks get drawn down. However, even during the twin energy crises of the 1970s and the run-up to $145-a-barrel oil in 2008, the Organization of the Petroleum Exporting Countries and other producers retained the capacity to pump more oil. By the end of 2022, the pair counsel in their third-quarter letter, "our models tell us this cushion will have eroded completely."

Over the past decade, the United States has served as the global swing producer of oil. Analyzing well data from U.S. shale basins, the G&R partners find that every basin excluding the Permian appears to have reached peak production, as E&P companies have already drilled their most lucrative acres. While there is more oil in these reservoirs, it will be more expensive to pull out.

Nor, our friends believe, does the oil cartel have as much spare capacity as claimed. For example, though Saudi Arabia asserts the ability to pump 12.2 mbpd, it has, they conclude, "only produced above 10 [mbpd] on two occasions and both times it was for only a brief period and the fields had to subsequently be rested.... Assuming Saudi has pumping capacity for 10.5 [mbpd] (a big if), we believe total OPEC+ crude capacity to be 46.9 [mbpd]—not enough to meet global demand by 4Q22."

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Erle P. Halliburton, HAL's founder, seemed not to be working with a branding consultant at the 1919 inception of what he baptized his New Method Oil Well Cementing Company. But that name soon proved more than just a catchy phrase as Halliburton's innovation capped a raging gas-well fire in Wilson, Okla., in 1920. Halliburton has since piled up innovations and strategic successes alike—as to the latter, for instance, it became the first American oil-services company to win a contract in mainland China, in 1986. There were setbacks, too, including the fatal 2010 Deepwater Horizon explosion, over which Halliburton paid $1.1 billion to settle claims against its allegedly botched cement work.

Today, Halliburton is the world's third largest oil-field-services company, after Schlumberger N.V. and Baker Hughes Co., with $14.3 billion in revenues in the 12 months ended Sept. 30. Completion and production, as the larger of the two business units is designated, spans cementing as well as well stimulation, intervention, pressure control, artificial lift and pipeline and process services; it delivered 55%

of 12-month trailing revenues. Drilling and evaluation, the smaller of the two units, supplies field and reservoir modeling, fluids and specialty chemicals, drill bits and services and project management, among other lines; it chipped in the remaining 45%.

While Halliburton is active in more than 70 countries, North America accounts for 41% of its trailing revenues, followed by the Middle East and Asia (26%), Europe, Africa and former soviet republics (18%) and Latin America (15%). Peers Schlumberger and Baker Hughes generate a higher proportion of sales outside the 50 states.

The bull case for Halliburton does not entirely hinge on valuation, but the relatively undemanding multiple of the stock price doesn't hurt. At $28.60 a share (disappointingly, from our vantage point, the price has squirted higher in recent days), HAL trades at 16.7 times this year's estimated earnings per share and 12.6 times the 2023 guesstimate.

There would seem to be plenty of room for growth. As recently as 2018, the company logged $24 billion in revenue. In the long-ago peak year of 2014, the top line fell just short of $33 billion. This year the Street expects $18 billion, with $20.1 billion in the cards for 2023.

"We believe that we're in the early innings of a multiyear up cycle," Halliburton CEO Jeff Miller told his audience on the July 20 second-quarter earnings call. "For the first time in seven years, we anticipate simultaneous growth in international and North America markets." In support of his bullish outlook, said Miller, "global demand will continue to exceed supply… [after] multiple years of underinvestment… [and the] high decline rates in U.S. shale."

Despite the precipitous drop in drilling over the past decade, the oil-field-services industry boasts surprisingly little spare capacity. Penny-pinching E&Ps, titrating their capex and conscientiously sending excess cash to the shareholders, are hardly the big spenders of yore. At that, Halliburton is projecting a major deceleration in its own capital spending, i.e., to 5%–6% of sales (versus a peak of 12.5% in 2012), an approach mirrored by Schlumberger's capital spending forecast, i.e., to 5%–7% of sales (versus 11.2% in 2012).

A wave of services-industry consolidation that the post-2014 energy-price collapse set in motion may deliver less-intense competition and higher profit margins. Pressure pumping—fracturing a shale well with fluids to increase the flow of oil and gas—illustrates the point. Thus, in 2020, Liberty Oilfield Services, Inc. purchased Schlumberger's OneStim pressure-pumping unit in a transaction that left Halliburton as the only fully integrated service provider—the sole company offering one-stop E&P shopping—in North America.

So far, such deals (there are many others) do not appear to have attracted the attention of the Department of Justice or, for that matter, Sen. Elizabeth Warren's Twitter account.

"In addition to consolidation, historically one of the factors that disrupted pressure pumping supply/demand was new, private-equity backed players entering the segment," Stephen Gengaro, who rates HAL a buy for Stifel Financial Corp., advises his clients. "Given the higher level of investment required to participate in the business coupled with the fact many private equity players are focused on ESG-friendly businesses, we do not expect a significant amount of private equity dollars will be available to fund new participants."

Legacy participants, too, may soon be paying more to drill and develop wells, their vows of spending discipline notwithstanding. Since the start of the pandemic, E&P companies have maintained production by running down their backlog of drilled but uncompleted wells, reducing inventory of such DUCs to 4,855 in November 2021 from 8,479 in March 2020. "These same operators will need to overcome a lack of inventory this year, which could require a mid-teens rise in maintenance capex," advises Bob Brackett, who covers E&P companies for Sanford Bernstein & Co.

In a December 29 energy survey, the Federal Reserve Bank of Dallas found that 78% of E&P firms polled planned to boost capital spending this year while just 8% intended to reduce investment. "We are seeing an across-the-board increase in demand for our services," one oil-services firm told the Dallas Fed, "but we are fighting to get back to acceptable margins for our products and services."

Halliburton, meanwhile, continues to innovate, in the third quarter introducing IsoBond, a dry blended cement that, by removing liquid additives, lowers capital costs for the E&P user. Software, too, is on Halliburton's high-margin product menu. For E&Ps, better software means sharper insight into projects, faster problem solving and more sure-handed control over operations. For its part, Halliburton finds it cheaper and more productive to monitor a client's well from the convenience of a digital hub rather than on site.

Extracting hydrocarbons is the point of it all, though Halliburton says that it's finding ways to do the dirty brown work in a greener fashion. One way is by swapping out diesel-run fracturing fleets for electric—or natural gas–powered—ones. (According to Goldman Sachs Group, Inc., around 90% of HAL's fleet consists of the

Halliburton Co. at a glance
all figures in USD millions except per share data

	TTM*	2020	2019	2018	2017
revenues	$14,255	$14,445	$22,408	$23,995	$20,620
operating income	1,154	-2,436	-448	2,467	1,374
net income	414	-2,942	-1,129	1,657	-449
earnings per share	0.45	-3.34	-1.29	1.89	-0.51
shares	895	881	875	877	861
cash	2,632	2,563	2,268	2,008	2,337
debt	9,125	9,827	10,327	10,344	10,942
assets	21,025	20,680	25,377	25,982	25,085

* The 12 months ended Sept. 30, 2021.

source: company reports

lower-emission units.) Management advised listeners-in on the third-quarter call that the greener fleet commands premium prices, and that a 2022 price increase was in the cards for dirtier diesel-only equipment, too.

Whether such initiatives—along with a Halliburton Labs unit, which invests in and provides technology, office space and know-how to new energy start-ups—will make HAL palatable to the ESG-minded endowments and pension funds remains to be seen.

At the end of the third quarter, Baa1/triple-B-plus-rated Halliburton showed net debt of $6.5 billion, or 2.6 times trailing Ebitda and 1.9 times this year's Ebitda estimate. The creditors seem content enough as the senior unsecured 2.92% notes of 2030 change hands at $100.60 for a yield to maturity of 2.8%, or a 96 basis-point yield spread above Treasurys, in line with similarly rated issues. Management says it's pointing toward a ratio of debt to Ebitda of around 2 times, after which it plans to conduct share buybacks and mail dividend checks to the stockholders.

With 23 of the 30 analysts following HAL rating the stock a buy and only two a sell, the Street is friendly with Dick Cheney's alma mater (George W. Bush's vice president was chairman of the board and CEO from 1995 to 2000). Short interest foots to just 1.7% of the equity float, though the insiders, if not actually bearish, nonetheless sold 128,712 shares, for proceeds of $2.8 million, over the past 12 months.

"The push for going all green will cause more energy shortages and much higher prices," the Dallas Fed's fourth-quarter survey quoted one energy company executive as saying. "Like the pilot said, 'Sit down and put your seat belts on. It's going to get a bit bumpy.' "

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