# Sometimes They Come Back

In 2016 I remember pitching the buyout of a distressed oil service sector company in front of an investment committee of a famous private equity firm. One of the convincing - at least I thought it was at the time - argument I made was that the oil price follows cycles, more or less correlated with global GDP, and my prediction was that we could expect a rebound two or three years down the line, even if we couldn't perfectly call the bottom.

That remark was greeted with smirks and pitiful eyes, as if I was failing the same exam with the same mistake for the umpteenth time and, it goes without saying, my pitch did not see the light of the day. Sad.

In any case, allow me to tell you a quick story.

The strategist and the fund manager.

A strategist tells a fund manager that his analysis shows that the oil price will go up on one of the following three years, but that the rally will be a surprise to the fund manager (like it has always been).

The fund manager thinks that the strategist is over the top and way off mark, as he himself is very good at forecasting price movements. In fact, having reflected on the strategist's analysis, the fund manager draws the conclusion that the oil price will never rally.

He starts by reasoning that the oil price cannot rally on the third year, because if it hasn't happened by the second year, there is only one year left and so it wouldn't be a surprise for him. Since the strategist stipulated it would be a surprise, then it cannot be on the third year.

He then reasons that the surprise rally cannot be on the second year either, because the third year has already been eliminated and if the rally does not happen on the first year, then it can only happen in the second year: but then it would not be a surprise either. By similar reasoning he also concludes that the rally cannot happen in the first year. Hence, he cheerfully goes back to his desk, confident that the oil price rally will not occur at all and modifies the investment portfolio accordingly.

The second year, the strategist sends an email to the fund manager with the chart in Figure 1 attached – which despite all of the above was an utter surprise to him!

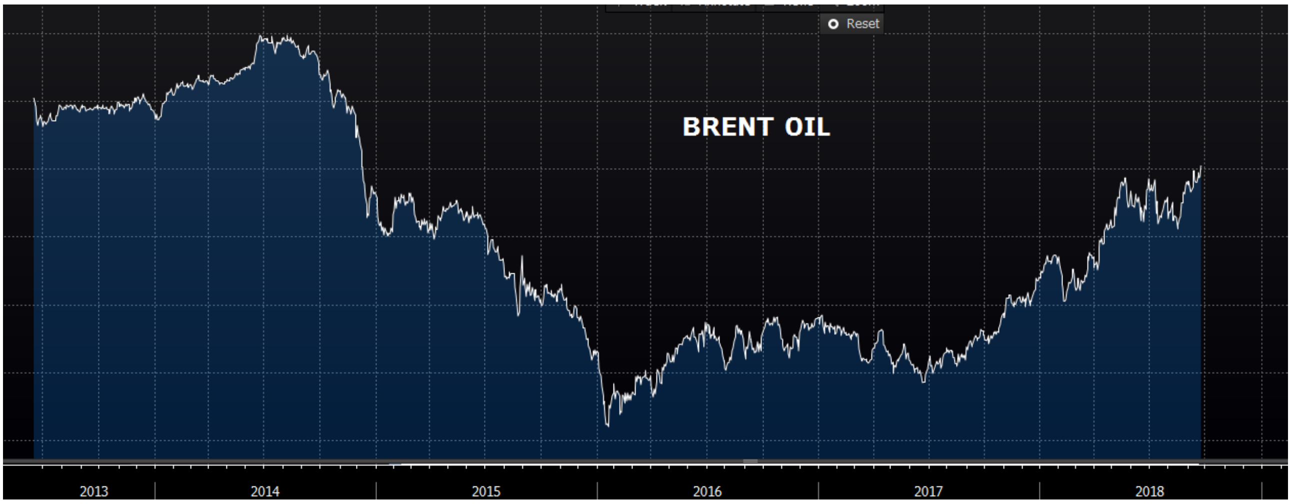


Figure 1 - Brent Oil Price

The oil price has rallied significantly over the last 12-15 months and is now back above $80 per barrel. This is an important piece of news for several reasons: for its macro impact, for the oil companies and the related service sectors, as well as geopolitically for the budget of exporting and importing countries.

Where are the opportunities?

Those who lived through the oil price collapse between 2014 and 2016 with correlated investments or trades remember vividly the pain and the losses. Among the most hit companies there were all those offering services that the major oil companies used to outsource, for example in exploration and production, ship and rig leasing, as well as transportation and maintenance. This complex motley crew of companies present all kind of entities: small cap or big cap, listed or private, extremely leveraged or conservative, local or global, with bonds, loans and equity in USD, EUR or NOK.

The common denominator is that the price of most, if not all, of those bonds collapsed, the equity value disappeared and many of the companies which survived, did so through restructuring processes. No wonder exposure to these risks from global portfolios has since virtually disappeared.

The oil price has shown strong cyclicality over time and so have investments in new projects, exploration, production and maintenance by the majors. There is a strong link between the investment decisions and the level of the oil price, because it determines a lot of the profitability and viability of the projects. It is therefore astonishing that last time oil price was above $100 per barrel, the majors were achieving only paltry margins. The reason was that the costs of executing and running the projects were extremely high. Hence, unsurprisingly when the oil price collapsed, the majors decided to cut investments mercilessly and since then they have only approved the bare minimum and exercised maximum control on costs, mindful of the latest experience.

For example, the UK North Sea this year has had the fewest exploration, appraisal and development wells since 1973.

Nonetheless, every action has its equal opposite reaction and, in this respect, it means that the oil reserves of the majors have not kept up with the depletion rate due to the lack of investments in exploration and related activities – drilling, renting equipment, leasing ships and rigs, engineering works, analyzing data, buying licenses and so on.

Now it seems that the time is ripe for a pick-up of these activities and an increasing oil price makes it easier to justify the expenses to the shareholders. Therefore, the pickup in demand for the oil service sectors seems inevitable.

The portfolio allocation opportunity lies in the potential of equity and debt of the related companies, which could see their values increase significantly when the increase in demand for their services materializes.

Impact of high oil prices.

There are several reasons why the outlook for the oil price has improved and it remains positive, with some prominent brokerage houses calling again a $100 target. A non-exhaustive list includes:

On the supply side:

- Geopolitical reasons
    - Venezuela massive production drop;
    - Libya difficulty with terrorism;
    - Iran sanctions.
- US shale oil and gas slowdown due to logistical challenges, rising costs for labour and equipment, environmental issues and lower efficiency of new wells. The debate is raging about whether this is just a pause or the end of the boom for the US shale industry.
- OPEC countries need for cash to balance their public budgets.

On the demand side:

- US growth is pushing on and global growth is still solid: the risks on the horizon (for example the trade wars) have not yet materialized in lower growth numbers.

High oil prices have many more ways to impact economies and financial markets than I am able to foresee. One major impact is on the macro economic activity. Oil price increases have a positive correlation with inflation rates and important effects on current account balances – increasing the deficit for the importing countries and the related need for USD (currently an important aspect for Emerging Market countries). The inflation pressure tends to depress the spending capacity of households given the rather inelastic nature of the oil demand, driving lower the private consumptions and eventually hindering the GDP growth.
Closely linked to the macroeconomic effect are the geopolitical repercussions, for example see the repeated requests from Trump to OPEC to increase production – with the latest one being rebuffed.
Another aspect of the high oil price is certainly the usually positive impact on the share prices of oil companies and the related sectors. This is what I am more interested in here.

Opportunities in bonds and equities.
I have split the oil universe roughly between big cap companies, which are all investment grade, and smaller companies, which all have high yield ratings. Figure 2 and Figure 3 show the yield and credit spread of a typical long maturity bond for each name in the big cap and small cap samples respectively.
A quick and dirty comparison with the spread on the ITRAXX index (or the CDX index for USD denominated bonds) shows that the big cap, investment grade bonds look relatively expensive and do not offer particularly attractive returns. For example, their spreads are all below the spreads of the main indices. One might wonder how much the QE has helped the bonds in this sector, but in any case, they don't give any reason for self-gratification.
The small cap, high yield bonds offer a more mixed picture, with several names in the sample paying interesting yields and being cheaper than the index in spread terms. While I am writing this piece, there is a new issue in the market from Floatel International for 475mio USD and a 9%+ yield, which gives a useful reference point. It is a leading company which leases accommodation rigs and the bet is, like for the rest of the sector, that they will experience a turnaround in demand and pricing power in the next few months.

| | Big Cap - Bonds | | | | | | |
|---|---|---|---|---|---|---|---|
| | Name | Maturity | Ccy | Ratings | Yield % | Z-Spread bp | Itraxx/CDX bp |
| Majors | Shell | 10y | EUR | Aa2/A+ | 1.31 | 30 | 113 |
| | Total | 10y | EUR | Aa3/A+ | 1.19 | 18 | 113 |
| | BP | 10y | EUR | A1/A- | 1.51 | 52 | 113 |
| | Eni | 10y | EUR | A3/A- | 1.9 | 88 | 113 |
| | Exxon | 10y | USD | Aaa/AA+ | 3.52 | 41 | 110 |
| | Equinor | 10y | USD | Aa2/AA- | 4.04 | 91 | 110 |
| | Equinor | 10y | EUR | Aa2/AA- | 1.57 | 60 | 113 |
| Services | Schlumberger | 7y | USD | Baa1/AA- | 4.02 | 91 | 110 |
| | Halliburton | 7y | USD | Baa1/A- | 3.97 | 86 | 110 |
| | Kinder Morgan | 8y | EUR | Baa3 | 1.89 | 105 | 113 |

Figure 2 Selection of bonds of oil majors and big cap service companies.

| HY - Bonds | | | | | | |
|---|---|---|---|---|---|---|
| Name | Maturity | Ccy | Ratings | Yield % | Z-Spread bp | Itraxx/CDX bp |
| Saipem | 5y | EUR | Ba1/BB+ | 3.03 | 245 | 272 |
| Oceaneering | 5y | USD | Ba1/BBB- | 5.42 | 232 | 317 |
| Ultrapar Int. | 5y | USD | Ba1/BB+ | 6.56 | 345 | 317 |
| Newfield Expl. | 7y | USD | Ba1/BB+ | 4.79 | 169 | 317 |
| Murphy Oil | 5y | USD | Ba3/BBB- | 6.69 | 353 | 317 |
| Seven Generations Energy | 7y | USD | Ba3/BB | 5.9 | 280 | 317 |
| QEP Resources | 5y | USD | Ba3/BB | 6.31 | 320 | 317 |
| Nabors Industries | 5y | USD | Ba3/BB | 6.51 | 341 | 317 |
| Range Resources | 5y | USD | Ba3/BB+ | 5.72 | 262 | 317 |
| Diamond Offshore Drilling | 5y | USD | B2/B | 7.26 | 415 | 317 |
| Ensco | 5y | USD | B3/B | 7.86 | 476 | 317 |
| Tullow Oil | 5y | USD | B3/B | 7.48 | 439 | 317 |
| Rowan Cos | 5y | USD | Caa1/B- | 7.5 | 440 | 317 |
| Noble Holding | 30y | USD | Caa1/B | 9.36 | 621 | 317 |
| Transocean | 10y | USD | Caa2/B- | 8.32 | 517 | 317 |
| New Issue | | | | | | |
| Floatel | 5y | USD | NR | 9-10 | | |

Figure 3 Selection of bonds of small cap companies in the oil sector.

Perhaps even more interesting is an analysis of the equity of these companies.
Figure 4 shows the P/E and the total returns for Oil Majors and Big Cap Service companies. It seems that the stock prices of the majors have fully discounted the rally in oil price both over the last two years and YTD (although their P/E still look reasonable), while that does not seem the case for most of the service companies. The stock prices for this latter lot have not increased yet in anticipation of the oil rally. Looking at their P/E, it probably means that the market does not yet have confidence in them being able to generate higher earnings. Opportunity!

| | Big Cap - Equity | | | | |
|---|---|---|---|---|---|
| | Name | P/E | EV/EBITDA | TOT RET % from Jan/2016 | TOT RET % YTD |
| Majors | Shell | 11.20x | 5.60x | 70.15 | 10.61 |
| | Total | 13.00x | 6.30x | 57.89 | 24.56 |
| | BP | 12.70x | 5.00x | 102.52 | 16.8 |
| | Eni | 12.20x | 3.50x | 45.94 | 26.3 |
| | Exxon | 16.00x | 7.30x | 23.43 | 6.28 |
| | Equinor | 13.30x | 3.50x | 113.12 | 35.49 |
| Services | Subsea | 26.50x | 6.80x | 110.52 | 4.09 |
| | Schlumberger | 25.50x | 12.10x | -4.28 | -6.38 |
| | Halliburton | 16.90x | 9.10x | 27.09 | -14.16 |
| | Kinder Morgan | 18.50x | 10.40x | 32.33 | 0.9 |
| Main Indices | ESTOXX | 16.20x | | 20.16 | 0.94 |
| | S&P | 21.20x | | 53.51 | 10.86 |
| | NIKKEI | 17.30x | | 37.5 | 7.3 |

Figure 4 Selection of equities of oil majors and big cap service companies.

Figure 5 summarizes the same indicators for the stocks of small cap, high yield companies. It is difficult to get a sense for the whole niche here, because the idiosyncratic risk is probably dominant with big differences from stock to stock in terms of actual and potential revenues and earnings. Maybe the only shared attribute here is that the total returns so far have not been strong – they are almost all below those of the main equity indices. Again, exposure to this sub-sector might be the right thing if the assumption of the recovery of the oil cycle is confirmed.

| HY - Equity | | | | |
|---|---|---|---|---|
| Name | P/E | EV/EBITDA | TOT RET % from Jan/2016 | TOT RET % YTD |
| Saipem | 46.50x | 7.60x | -42.18 | 38.36 |
| Oceaneering | n/a | 16.50x | -23.78 | 31.98 |
| Ultrapar Int. | 14.30x | 7.60x | -28.27 | -56.91 |
| Newfield Expl. | 7.00x | 4.60x | -9.67 | -7.48 |
| Murphy Oil | 16.10x | 4.50x | 59.19 | 7.89 |
| Seven Generations Energy | 8.40x | 4.00x | 11.5 | -15.47 |
| QEP Resources | 150.30x | 5.10x | -16.79 | 16.41 |
| Nabors Industries | n/a | 5.80x | -22.39 | -8.19 |
| Range Resources | 15.90x | 6.40x | -30.6 | -0.67 |
| Diamond Offshore Drilling | n/a | 15.60x | -8.11 | 4.19 |
| Ensco | n/a | 22.40x | -45.78 | 39.32 |
| Tullow Oil | 10.20x | 5.40x | 83.47 | 25.17 |
| Rowan Cos | n/a | 70.30x | 7.32 | 16.22 |
| Transocean | n/a | 11.60x | 8.17 | 27.2 |
| ESTOXX | 16.20x | | 20.16 | 0.94 |
| S&P | 21.20x | | 53.51 | 10.86 |
| NIKKEI | 17.30x | | 37.5 | 7.3 |

Figure 5 Selection of equities of small cap companies in the oil sector.

Conclusions.

If you feel like the fund manager of the initial story don't be too worried: we have all been there sometimes. Maybe many times. The reality is that investing and trading proceed under the tyranny of uncertainty: it is like going somewhere with a general sense of destination but without a clear route. The leap of faith is that we are going to be able to figure out the right strategies in due course.

Since uncertainty is inescapable, we need to accept that there is a lot of luck involved in identifying the right strategy, hence I focus more on the process: good quality decision making is more important than good quality outcomes. My resolution is that I will be brave and so, unlike the fund manager that is always surprised I will follow my analysis and act before it's too late.

I think that 2019 has the potential to be a pivot year for risky assets and rather than betting on outright increase or decrease of general market prices, I prefer to do relative value trades and sector turnovers. The oil sector seems still unloved in some niches, hence the potential to generate above average returns.

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