Alphinity
INVESTMENT MANAGEMENT

Sector spotlight

December 2014

Each quarter, Alphinity Investment Management's portfolio managers share their expert views on the trends and themes emerging within their relevant sectors. This quarter, Stephane Andre shares his thoughts on the recent sharp decline in the oil price and developments within the resources sector.

Who: Stephane Andre

Role: Principal and Portfolio Manager

Sector responsibilities: Energy, materials and resources, industrials

Industry experience: 20 years

What have been the drivers for the recent decline in the oil price? Have the supply/demand fundamentals changed significantly?

The sudden fall in the oil price has surprised many, including us. The oil price has more than halved since June 2014 when it was $115/barrel (bbl), to a current low of $55/bbl; its weakest since October 2009. This follows nearly five years of stability, with oil prices fluctuating within the $US100-$US120/bbl range since 2010. So why is the price of oil falling? The reasons for this are two-fold;

- **Demand has been slightly weaker this year** due predominantly to weaker economic activity, with a global growth of 0.8 million barrels per day (mbpd), slightly lower than the 1.3mbpd initially expected for 2014.
- More importantly, the **U.S. supply has continued to surprise**, adding 1.4mbpd in 2014, a level which exceeded the entire global annual demand growth. Similar supply growth is forecast for 2015. To balance the market it was expected that the Organisation of Petroleum Exporting Countries (OPEC), in its role of swing supplier, would not only adhere more strictly to its 30mbdp quota (which it was over producing by 0.6mbpd in any case) but would reduce its own quota to about 29.5mbpd.

The oil price continued to fall on 27 November 2014 when OPEC announced it would not prop up prices by cutting its production quota, shifting the 92mbpd global oil market into an excess of around 1mbdp. The supply adjustment will therefore need to take place outside of OPEC and will have to be forced through an oil price low enough to trigger the necessary supply destruction. U.S. oil production will most likely be the main source of reduction as much of it has a relatively high production cost and its capex expansion is the most discretionary and fastest to adjust. The process could however take up to 12 months to allow producers to react and cancel drilling contracts. Barring any geo-political supply disruption taking place, it is therefore reasonable to expect a low oil price in the short term.

What is your view on oil prices going forward? Is $60/bbl the new normal?

We don't believe so. We expect the price to eventually readjust to a higher level to support supply growth as the oil market remains tight in the medium-term. Every year, oil field production naturally declines by about 4%, which means that in order to respond to a 1% increase in demand growth, a 5% supply growth is required. That incentive level is believed to be around $80-90/bbl although this assumption is tested against the current shift in production cash cost curves.

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Who are the beneficiaries and losers of a lower oil price?

Supply-induced price falls are generally good for global growth, with some economists expecting a 0.5% lift of global GDP growth should the current oil price be sustained for a while.

The main beneficiaries of a lower oil price are;

- Net importing nations (most notably Japan, China, India and Europe)
- Countries which presently subsidise domestic oil prices
- Individual consumers who are benefiting from lower pump prices in countries where the pass through mechanism is not heavily affected by taxes (such as Australia and the U.S.)
- Businesses which use a lot of oil as an input cost, such as the airlines.

Some of the lower oil price benefit is tempered by a strengthening USD.

The obvious losers from the fall in the oil price are the producers and exporters of oil (including OPEC, Russia and Brazil), as are companies linked to their exploration and production activities (engineering, drilling and servicing companies).

What does this mean for energy producers within the Australian market?

All Australian oil and Liquefied Natural Gas (LNG) producers (the LNG price is typically linked to oil) will see their earnings and free cash flow adversely affected by the 45% fall in the A$ oil price as they typically don't hedge against oil price fluctuations.

The companies that fare better under a lower oil price environment are those with strong balance sheets, minimal capital obligations, and positioned on the lower end of the operating cash cost basis. These companies will attempt to leverage their relative strength. Woodside Petroleum and Oil Search sit within this category. Woodside has recently acquired Apache Corporation's interests in two large LNG projects, lifting its production profile and growth options at a reasonable price. Oil Search will most likely make use of the lower oil price to develop some of its organic growth options, once confirmed, at a lower development cost.

On the other hand, Origin Energy and Santos face more short-term pressure from the equity market and rating agencies to protect their funding positions and investment grades under a lower oil price. Both companies are highly leveraged and still need to complete their respective LNG projects in Gladstone. In response, they are cutting discretionary expenditures, delaying projects and assessing asset sales. Their share prices are therefore more leveraged to the oil price, on both the up and down sides.

For more information please contact our Investor Services team on 13 51 53 or visit alphinity.com.au

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