WILSONS

Energy – Ready for Take-Off?

Our weekly view on Australian equities.

3 December 2020

Could Restrained Oil Supply Send Prices Higher?

Oil prices averaged ~US60/bbl across 2018/2019 leading into the COVID-19 pandemic. Today, the oil price is just $US45/bbl for both WTI and Brent. While oil has recovered from COVID-19 lows in the $US20s in 2Q20, global oil demand remains materially below levels seen in late 2019.

In this week's Australian equities view, we look into the likely demand and supply drivers of oil across 2021/22 as the world begins its post-COVID-19 cyclical upswing.

While the demand for oil in 2Q20 fell at a pace like we have never seen before, the potential for a constrained oil supply from 2023 onwards could be the precursor to higher oil prices relative to expectations. In our view, the potential for supply tightness could drive a further leg of recovery in the oil price.

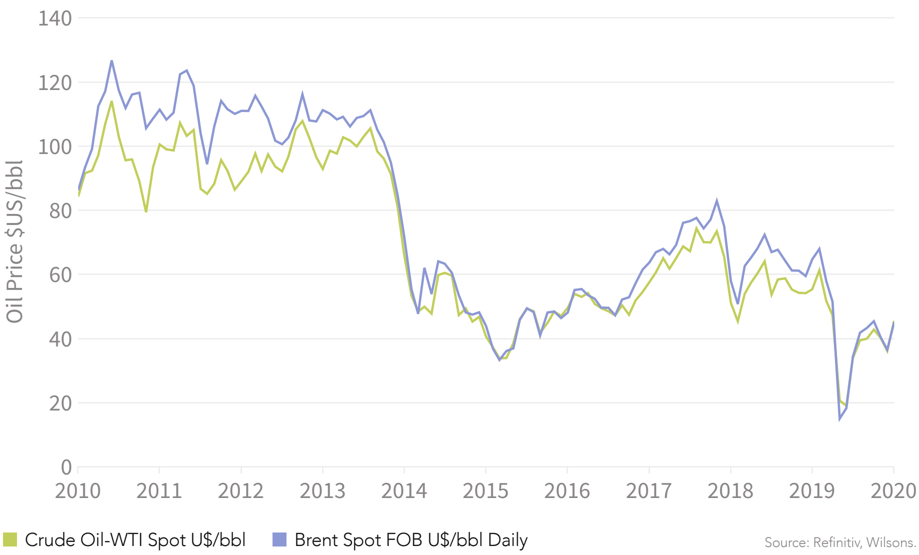
Wilsons Australian Equity Focus list

The Wilsons Australian Equity Focus List is overweight the energy Sector. We see the sector as being a beneficiary of the economic reopening. Share prices in our view do not fully reflect a vaccine-led reopening scenario, which we think will gather momentum through the early part of 2021.

COVID-19 Oil Demand Destruction and Recovery

As the world went into lockdown in March and April, it is estimated (IEA) that there was ~30-40% loss of oil demand as consumers and industry simply stopped consuming. A demand crunch like no other, the scale of the impact was clearly visible with airports used as parking lots or ships being used as temporary storage.

Exhibit 1: Oil prices have staged a recovery but remain below incentive prices for most new oil supplies



Source: Refinitiv, Wilsons.

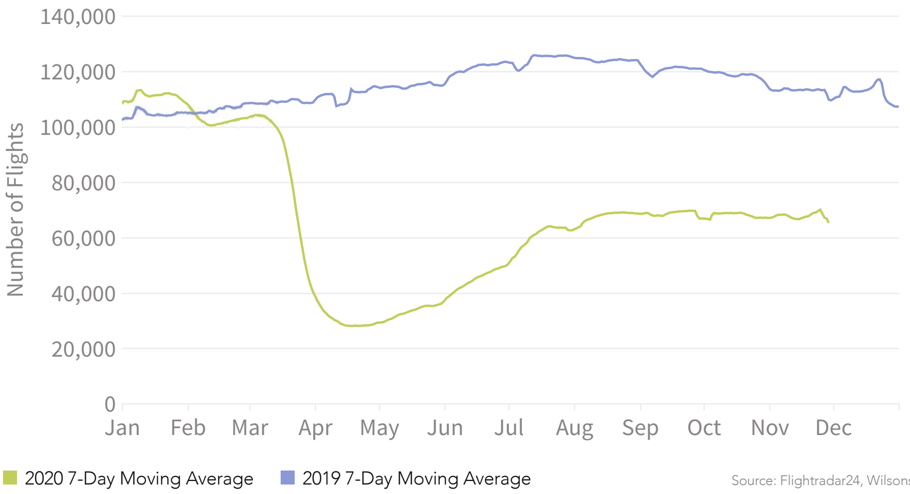
Exhibit 2: Oil demand is currently around 5% below pre-COVID-19 levels

Source: Refinitiv, UBS, Wilsons.

While demand has recovered from those heavily depressed levels, it remains around 5-6MMboe short of, or around 5-6% of pre-COVID-19 levels. This demand is likely to return through 2021/22 as the reopening of the global economy takes place. Demand has returned strongly in China and also parts of the US as gasoline demand has quickly been restored. Demand for jet fuel (8% of global demand) could rebound quickly in 2021 as vaccine take-ups open up cross-border travel.

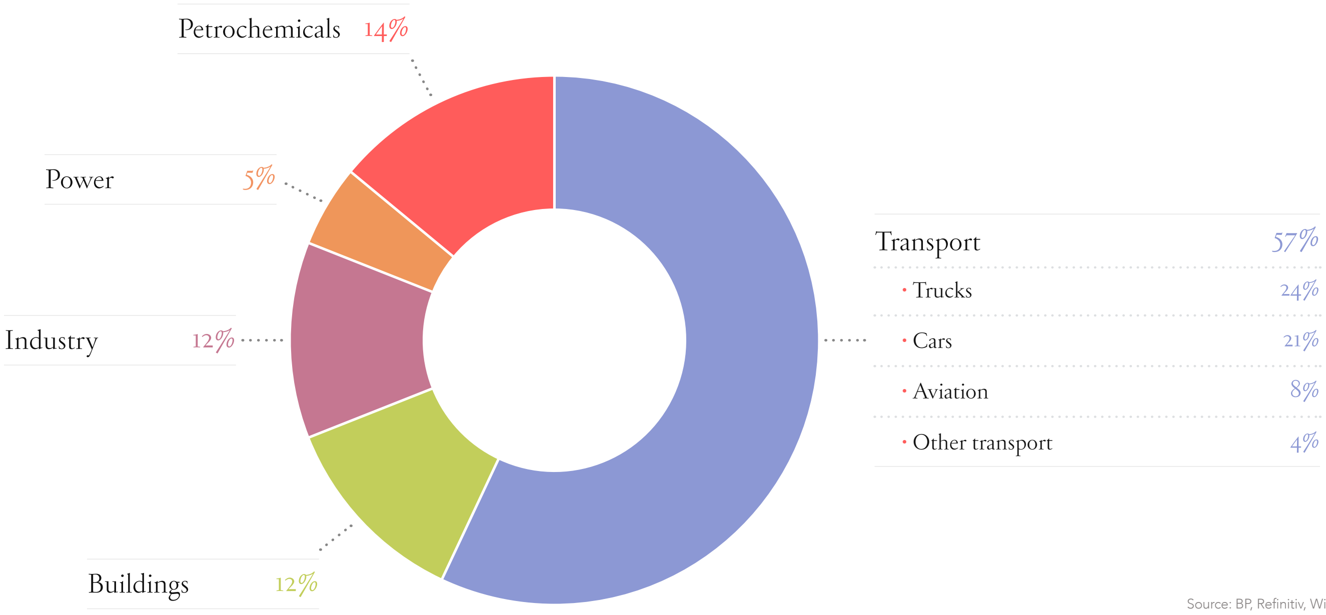
Our central case remains that global oil demand will be restored relatively quickly to pre-COVID-19 levels. The long-term transition to green energy will not happen fast enough to prevent oil demand surpassing 2019 levels.

Exhibit 3: US commercial flights remain 50% below 2019 levels



Source: Flightradar24, Wilsons.

Exhibit 4: Industry demand for oil - Transport at 60% of consumption is likely to rebound quickly in 2021/22



Source: BP, Refinitiv, Wilsons.

We believe the demand for oil could actually return much faster than the market is thinking. Emerging market GDP growth, which is more oil intensive than in developed markets, is expected to grow +6% versus <4% in developed markets in 2021. Into the 2H21, developed market recoveries should begin to look more convincing particularly across Europe and the US.

COVID-19 CAPEX Cuts Likely to Constrain Supply Growth

After the significant dislocation in oil markets during March/April 2020, oil supplies adjusted downwards primarily as OPEC+ producing nations held back supply to the tune of 6MMboe a day. OPEC effectively allowed its market share to fall to ensure the market remained in balance.

While there is debate around how long these OPEC supply restrictions will be in place (OPEC decision due at the end of this week), no other region/producer group has the capacity/volume to meaningfully restart supply. The US shale oil fields are more difficult to restart, with flat to declining volumes.

The restarting of suspended supply is just one aspect of the supply picture. The more lasting, and potentially more impactful event is the curtailment of energy CAPEX. This is likely to lead to lower oil supply growth over the medium-term, potentially creating materially tighter oil markets than what the market is anticipating.

We estimate that CAPEX budgets for the 6 largest global oil producers have been cut by 30%, or more than $US40bn in 2020 due to COVID-19, with this level of reduced CAPEX continuing into 2021 and 2022. Global oil consultants, Wood Mackenzie, estimate that we will see a reduction of global oil supply by 5MMboe per day across 2021-2025 relative to pre-COVID-19 estimates.

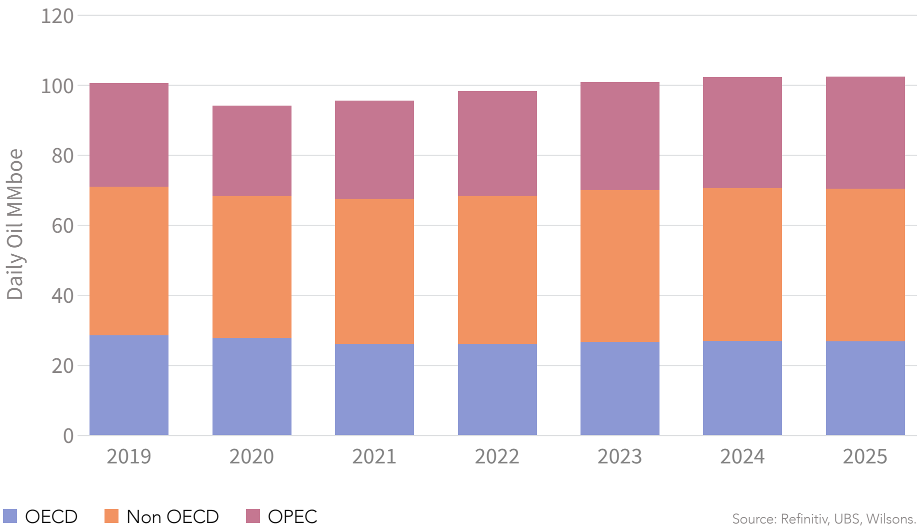
BP has gone further and is actively transitioning its business away from hydrocarbons, looking for 40% reduction in oil volumes by 2030.

Against this backdrop, we estimate the incentive price for new investment in oil supply (ex OPEC) is at a margin of $US60-70/bbl. Medium-term risk of supply undershoot is material, particularly from 2023 onwards, which could result in much higher oil prices.

Market Expectations for Pricing

The forward curve for WTI crude oil is flat, even dipping into backwardation, with prices hovering around $US43-44bbl across 2021-2023.

Exhibit 5: Global oil supply – OPEC lost share in 2020 remains the key focus for 2021



Source: Refinitiv, UBS, Wilsons.

Analyst consensus estimates are more bullish, with WTI forecasts $US46bbl 2021, $US52 bbl 2022 and $56bbl 2023.

On either price estimate, we think the cyclical recovery is being discounted too aggressively. The oil 'surpluses' in the current market could be consumed quite quickly as the economic recovery takes hold. Looking further out, the risk of supply undershoot is building.

The Focus List's Position in the Energy Sector

The Focus List is overweight energy, through exposures to Santos (STO), Worley (WOR) and BHP Group (BHP) (which has ~10% of its earnings coming from oil).

From an oil price perspective, STO, WOR and BHP are positively correlated at 0.66, 0.64 and 0.64 respectively (15yr historical correlation), which is towards the higher end of oil price correlations across the sector.

While the oil price is important, our investment case for STO is premised on its ability to grow production volumes by +60% into 2025. If achieved, this will deliver the highest earnings growth of the major oil producers in Australia, potentially opening up a door for the share price to re-rate. STO recently upgraded FY21 production guidance, and while small at <5%, this is something we are likely to see regularly over the next few years.

The STO share price has performed strongly in November, up 30%. Relative to peers, STO still screens more attractively on a FY20 EV/EBITDA basis at 4.7x, Woodside Petroleum (WPL) 4.9 versus Oil Search (OSH) 5.6x. On a price to NPV basis, STO 0.7x versus 0.8x for both WPL and OSH. With a clearer line of sight to deleveraging the balance sheet, 30% gearing FY20, through asset sell downs/in-specie distributions after this week's strategy day, STO continues to be our preferred energy producer.

WOR into FY23 is very much an earnings recovery story driven by volume growth across oil, energy and chemical industries. The market, in our view, still perceives WOR as a pure-play oil services company.

Following the acquisition of the Jacobs assets, direct oil-linked work is now less than 40%. Importantly, the company has pivoted away from CAPEX related work to OPEX related work – which should show less cyclicality.

We think the market is yet to fully appreciate this aspect, with WOR trading at a discount to the market on an earnings multiple. If WOR can demonstrate greater earnings resilience, a higher multiple awaits.

As a diversified miner, BHP has reasonable exposure to conventional oil both in terms of volumes and pricing impact on earnings. BHP provides the Focus List with broad-based cyclical exposure to the global growth recovery thematic.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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