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Oil in Flames: Game Changer?

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SUMMARY

The latter half of 2014 saw the second largest annual drop in oil prices ever, down 50%. Will the new environment be a game changer for the industry? We look at market share dynamics, production costs, and producer strengths/weaknesses to handicap the outcome. Our conclusions:

- Over-supply will likely remain for an extended period, keeping oil prices historically low and flushing out weaker producers. But the broad impact is favorable: cheaper oil should help the global economy and keep inflation in check.
- Successful US producers must have healthy balance sheets and efficient operating models to handle the re-pricing. While the shakeout is cloudy, our existing investments appear to have ample margin for error. Our research also sees incremental opportunity.
- US shale production is here to stay. US firms are improving operations and have every incentive to address regulatory concerns of "fracking," a controversial drilling technique. Continued success could shift the balance of power incrementally away from OPEC.
- Russia certainly presents a wildcard. Its currency reserves and US-denominated debt could worsen a looming recession, if oil drops further. Contagion to other emerging markets is possible but appears manageable in most cases.

ANALYSIS

Our clients know that we do not use macro predictions or "big picture themes" to drive our investment decisions. Instead, we base our decisions on fundamental financial information that is objective and measurable. We believe this minimizes human error, helps us recognize valuation extremes, and improves our chances of buying at low prices and selling at higher prices.

Still, we must be vigilant for rare events that change an industry or render financial data less meaningful. We saw this when sweeping regulation changed the profit models of for-profit education stocks. It's also why we historically tend not to invest in airlines, given the industry's high fixed costs and lack of pricing power. We risk buying low and selling lower.

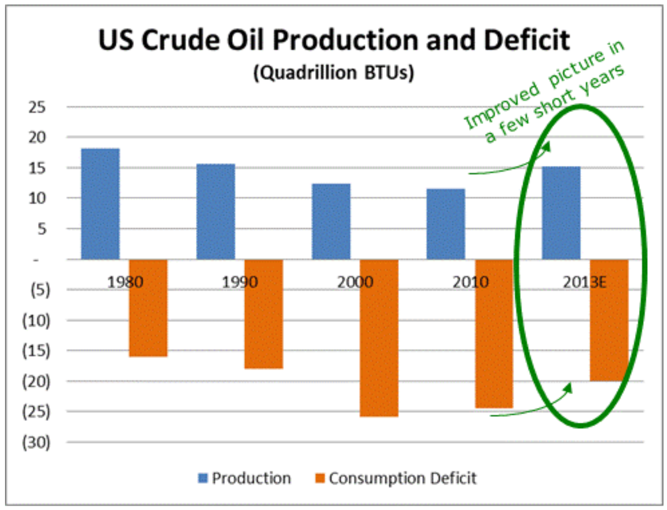
Amid the historic drop in oil prices, we thought we'd review the implications for the industry, sovereign nations, and our portfolios.

We'll do so in three charts.

Chart 1: Trends in US Oil Production and Foreign Dependence on Oil
Message: Fracking Reinvigorates US Energy Strength

From 1970 to 2010, US oil production was falling (blue bars in chart) as consumption generally rose, creating a big consumption deficit (the orange bars in the chart) and making the US heavily reliant on foreign producers.

Of late, this picture has begun to change. Since 2000, US oil consumption has been dropping and natural gas production increasing, **but the real story is that US oil production is up a whopping 31% since 2010**, **which has helped close our oil deficit by 18%.**



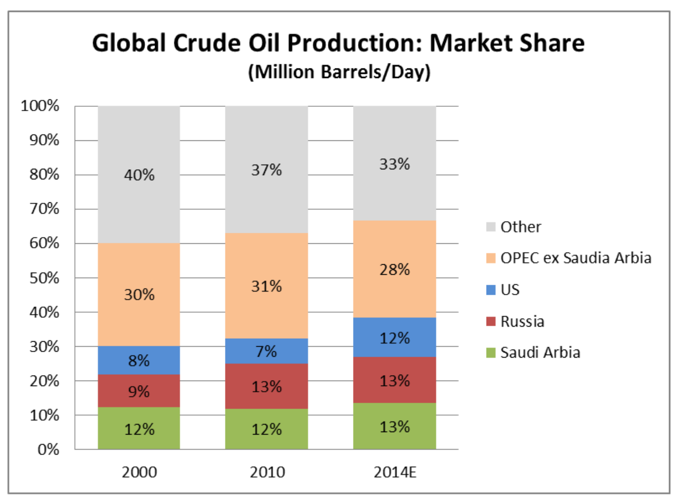
Source: US Energy Information Agency, CornerCap

This transformation is due to the rapid expansion of hydraulic fracturing, or "fracking," a drilling technique[1] used by US producers. Fracking offers two main benefits over conventional drilling: it is faster to set up drilling equipment, and it reaches untapped sources for oil and gas. Fracking now represents an estimated 20% of global production.

Chart 2: Crude Oil Market Share
Message: US and Russia now rival Saudi Arabia as producers; Game of Chicken in 2015?

After oil prices collapsed this fall (due to over-supply), Saudi Arabia, the de facto leader of the OPEC cartel, announced in November that OPEC will continue pumping oil, rather than curtailing it.

To put the decision in context, consider that Saudi Arabia's market share has remained flat since 2000, while Russia and



Source: US Energy Information Agency, CornerCap estimates

[1] Fracking involves blasting water, sand and chemicals into existing fissures in rock formations, thereby expanding them and increasing the flow of crude oil and natural gas for extraction. Invented in the 1940s, it has become the fastest method of production over the past few years as horizontal drilling methods improved and shale deposits offered untapped sources for crude oil and natural gas.

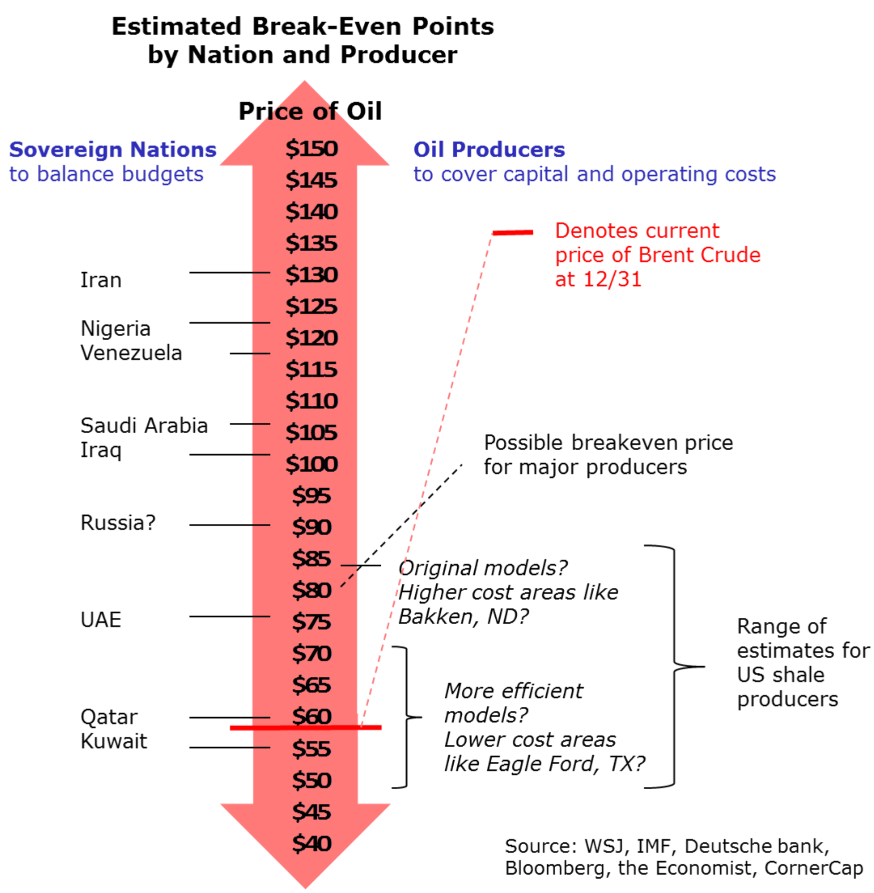
the US have caught up. The US has moved from 7% in 2010 to an estimated 12%-13% today.

What is the Saudi rationale for maintaining supply? To keep prices low and squash surging producers—namely, Russia, troublesome OPEC member Iran, and burgeoning shale drillers in the US. Flushing them out would put Saudi Arabia in a better position when oil prices improve.

Will the Saudi strategy work?

Chart 3: Estimated Break-Even Prices by Oil Producer

Message: The Saudi strategy has merit. It has a moderate cost advantage and financial strength to weather the storm. Higher cost US shale producers may fail, too, although some have ample balance sheets and improving cost structures to survive.



At current oil prices:

- Most oil producing nations will struggle to balance budgets. Iran, Nigeria, Venezuela, and Libya appear relatively worse off—high production costs and reliance on oil exports for income.
- Saudi Arabia feels pain here but is arguably one of the cheapest producers of oil from existing wells. Plus, it has ample foreign currency reserves and low national debt to weather a protracted storm.
- Multinational firms may begin to struggle at roughly $80 to cover capital and operating costs.
- Breakeven economics for US shale producers depend on location, transportation method (pipeline is cheaper than rail), and engineering services. Higher cost producers may need $85 prices, but those operating more efficiently or in lower cost areas might achieve breakeven at $50-$70, by some estimates.

In a high-stakes game of chicken, Saudi Arabia may blink at some point, but others are likely to blink first.

IMPLICATIONS

A boost to world economic growth: Lower oil prices bring meaningful savings for consumers and windfalls for countries with high oil net imports, such as Germany, France, India, Japan and even China. Cheaper oil also eases inflationary pressures that come from growth, which should help Europe as it combats potential deflation. Central banks may be able to keep rates low for longer.

Oil prices likely to remain low: Many oil wells have been deployed. Incremental cost of production is therefore low—perhaps $20 or less. Pumping from existing wells makes sense, even with tepid economic growth. Barring civil unrest or war, this should keep supply growing and oil prices low.

How long? This dynamic could persist for six to twelve months, given typical lead times, but at some point new wells must be deployed. Oil at $60 or below would likely discourage further supply, cutting production in half by some estimates. Once that occurs, prices may rise again. But the lag time likely creates a difficult window for the industry.

Mixed for US shale producers: Many shale producers have tapped the debt markets to support drilling. We've seen reports that 25% of shale investment is by firms with 3X debt to cash flow—arguably untenable. Sustained low prices will likely force some producers into bankruptcy, and many will need to cut capital spending and perhaps dividends to accommodate the new economics.

For CornerCap portfolios: Our US large cap research called for about 6% exposure to oil last summer. With the downdraft, it is now calling for about 11%. This compares to 11% then and 8% now for the S&P 500. We have been able to add some new investments (among those shown in chart at right), and expect to continue to do so.

Snapshot of Oil Stocks in Our Research Buy Group, by Selected Metrics

Stock	Ticker	Debt to EBITDA	Interest Coverage	Dividend Yield	FCF Yield	Decline off Summer High
Cameron International	CAM	1.9x	9.5x	0.0%	2.0%	-33%
ConocoPhillips	COP	1.0x	20.0x	4.2%	1.0%	-20%
Devon Energy	DVN	1.7x	8.0x	1.6%	N/A	-24%
Ensco	ESV	1.9x	13.1x	9.8%	-3.0%	-47%
Exxon Mobil	XOM	.4x	668.4x	3.0%	4.0%	-11%
Halliburton	HAL	1.1x	12.1x	1.8%	5.0%	-47%
National Oilwell Varco	NOV	.7x	36.2x	2.8%	6.0%	-23%
Occidental Petroleum	OXY	.6x	96.2x	3.5%	1.0%	-20%
Phillips 66	PSX	1.6x	11.1x	2.7%	1.0%	-17%
Schlumberger	SLB	1.0x	24.3x	1.8%	4.0%	-27%
Valero Energy Corp	VLO	.9x	14.3x	2.2%	10.0%	-17%

Yellow = point of concern

Snapshot of our Larger Oil-related Bond Holdings

Bond	EJ Rating	Debt to EBITDA	Interest Coverage	Dividend Yield	FCF Yield
Chesapeake Energy*	BBB	2.0x	12.1x	1.8%	N/A
Apache	BBB+	1.0x	36.0x	1.6%	-11.0%

* pre-asset sale; after sale, we estimate balance sheet will improve incrementally
N/A = not applicable due to recent acquisition

source: CornerCap, CapIQ, Yahoo Finance

Our existing large cap holdings are down off their recent highs this summer. We are not in the clear yet, as earnings outlooks are still in flux, but we believe the balance sheets of our holdings bring some margin for error, with debt at or well less than 2X cash flow ("Debt to EBITDA" in the chart). The larger risk we see is not bankruptcy, but getting an objective sell signal if earnings growth were to collapse, or to a cut in dividends at producers like Ensco (perhaps reflected to some extent in the price).

Potentially stronger position for the US long term: Despite the dislocation underway, we believe fracking is here to stay. Fracking must first become more environmentally friendly (see chart at right), and we expect regulations to tighten (as they should). But producers have every incentive to comply. Most analysts forecast a declining rate of production from shale as it matures, but the technique should spread to other parts of the world as an alternative to conventional drilling. OPEC and Saudi Arabia will retain power, but they likely won't have enough market share or internal discipline to dominate as before.

Snapshot: Fracking

Pros	Cons
Taps new sources for fossil fuels	Pollutes air by emitting methane and sulfur dioxide
Supports shorter lead times in oil production	Pollutes fresh water as chemicals seep
Helps make US more independent in energy	Drillers not required to disclose chemicals used, or to reuse water
	Drillers often exempt from regulations like the Safe Drinking Water Act
	State regulations are inconsistent

Source: CornerCap Investment Counsel

Pain for emerging market exporters, particularly those with debt denominated in US dollars: This is already happening. Venezuela, for example, derives 25% of its GDP from oil, and as the chart showing estimate break-even prices shows, it is well into damage territory. Inflation is already very high and threatens political stability. Even Brazil is not immune, given their corporate borrowing in US dollars.

RUSSIA: THE WILDCARD

Russia is clearly in a tight spot: heavy reliance on oil for exports and income, a declining ruble, western sanctions (no lending!), early inflation (a falling ruble means more expensive imports), and tight foreign currency reserves. On the positive side, Russia's national debt is low, it has a trade surplus, and the falling ruble temporarily softens the blow of falling oil prices (relative domestic prices stay the same) and helps exports like agriculture, which is important to Russia's economy. It is difficult to forecast what comes next.

If oil prices don't fall further and foreign capital doesn't flee, perhaps Russia can muddle through its looming recession. But the margin for error is tight:

- Russia's break-even on oil to balance its budget is reportedly around $90, which means deficits should mount, at a time that pressures for bailouts by the Kremlin are growing.

- Russia also has $360 billion in currency reserves (used to handle national liabilities and monetary policy) according to the IMF—ample at first glance, but it could be that $100 billion is not in available cash, and Russia reportedly used $100 billion in the past year to support the ruble.

- Foreign-denominated debt is about $600 billion (corporations are about 90%, but have strong links to the government), and about $130 billion must be repaid in 2015. Will western banks cooperate despite current sanctions?

The ripple effect of recession and defaults could easily reach the Baltics and Belarus (Russian imports are big for them), as well as lenders in Sweden and Austria.

BOTTOM LINE

Is the dramatic fall in oil price a game changer? Prices have fallen significantly many times over the years, forcing producers to cut spending and address weak balance sheets. What we think is different this time around is the role that US shale producers are playing, and the potential for fracking to be a legitimate alternative source to conventional drilling.

If supply stays high and oil prices low, we believe there will be a shakeout in the industry, affecting oil businesses and sovereign nations alike. In most scenarios, we suspect the benefits of cheap oil (boosting economic growth, taming inflation, helping Central Banks) will be greater than the negative impact. Eventually, once prices stabilize and climb, we suspect the US will be a stronger player and OPEC will wield reduced influence.

The wildcard during this period is of course, how cheap oil will affect Russia and how an expensive US dollar will squeeze foreign borrowers. If oil prices fall further, it could accelerate the problems of these countries and spread the pain. They will be dependent on healthier western nations and organizations like the IMF to come to their aid.

See our commentaries and newsletters at www.cornercap.com for more detailed discussion of our research and views about investing in today's markets.

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