The Contrarian Case for Energy

PERSPECTIVE FROM FRANKLIN EQUITY GROUP

KEY POINTS

• Our fundamental analysis leads us to believe that pricing pressure resulting from growing supply will face increasing opposition from decline rates as well as financial considerations and that an eventual recovery may, in fact, be more likely than suggested by some market participants.

• Somewhat lost in the discussion is that the amount of oversupply is fairly small in comparison with total global demand.

• In recent months, internal strife has grown within OPEC over the future strategic direction of the cartel as low oil prices have placed increasing fiscal pressure on a number of its member countries.

• While the shale oil industry has managed to confound those who expected high decline rates to result in a swift decline in production, a deeper analysis suggests the downward pressure on production is growing the longer the rout continues.

• Largely overlooked in the discussion has been the historic difficulty of finding new sources of reserves, which is of particular importance with much of current global production in perpetual decline.
Introduction
Over the first half of this decade, the increase in shale oil production has been nothing short of spectacular. Although hydraulic fracturing or “fracking” (as the technique for extracting oil from shale is known) has been utilized for decades, it has only been in recent years that persistently higher oil prices along with readily-available funding and improvements in technology have made it economically viable. Over that period, the United States has catapulted from a mid-level player to regain its status among the world leaders in terms of crude oil and gas production (Fig. 1). In the process, the US shale oil industry may be becoming the default swing producer for the global energy industry.

The term “swing producer” refers to the role played by a producing company, country or other entity influential enough to meaningfully impact the global balance between supply and demand. When this role is played by a single entity that can respond quickly, the resulting certainty it provides can be beneficial for producers and consumers. In the context of global energy markets, the Organization of the Petroleum Exporting Countries (OPEC) in general, with the Kingdom of Saudi Arabia as the largest player more specifically, has played this role over the past several decades and brought some degree of stability to the market. In comparison with the OPEC cartel, the US shale industry is made up of a myriad of independent producers governed by economic considerations more so than a desire for achieving market stability, and is therefore less capable of coordinated restraint, which may create a much less efficient balancing process compared with a cartel that can act more quickly and decisively.

The US shale oil complex did not assume the role of the swing producer willingly. Rather, it has largely been the result of a mostly Saudi-driven decision for OPEC to abdicate its role. The Saudis and their allies decided to impose production discipline on non-OPEC producers by increasing rather than decreasing production in a market that was already well-supplied, which helped drive global inventories higher and resulted in depressed oil prices and significant reductions in oilfield spending. As the Saudi oil minister Ali al-Naimi made clear in March of 2015, “It is...
not the role of Saudi Arabia, or certain other OPEC nations, to subsidize higher cost producers by ceding market share.” At a conference early in 2016, the minister reiterated his view that rebalancing is best accomplished through market forces “with a minimum of meddling” and that production cuts were not forthcoming.

Saudi Arabia and OPEC faced a similar situation in the early 1980s when the cartel significantly reduced production in an attempt to prop up prices as non-OPEC production grew, in response to historically high prices and supply concerns, from regions such as Alaska and the North Sea. Although this attempt buoyed prices temporarily, this simply encouraged the development of more supply during a period when consumption in Organisation for Economic Co-operation and Development (OECD) countries was falling precipitously due to increased fuel switching and efficiency gains. This resulted in a significant glut that represented over 20% of global supply and took nearly 20 years to absorb through limited supply additions and growing demand. Although the degree to which the market appears oversupplied today pales in comparison with the 1980s, OPEC appears to have chosen to swap near-term pain for long-term gain (as in 1985) by allowing prices to fall and market forces to begin balancing the market although OPEC made the decision much sooner this time.

The first sharp and sudden decline in the price of crude occurred around August of 2014 as concerns that Libyan and Iranian production could return to the market mounted. The rout deepened when, despite a period of lower prices and reduced drilling, shale production increased as wells previously drilled came on-line, thereby appearing more resilient than originally anticipated by some observers. Now, with the media playing no small role in publicizing a line of thinking that suggests production will remain resilient and low prices could be permanent, these events have had the unsurprising effect of severely depressing energy sector sentiment (Fig. 2). While the currently depressed
state of the industry is not in question, during this time we have found it useful to recall Sir John Templeton’s advice to “invest at the point of maximum pessimism.” Even as sentiment has worsened, our fundamental analysis leads us to believe that pricing pressure resulting from growing supply will face increasing opposition from decline rates as well as financial considerations and that an eventual recovery may, in fact, be more likely than suggested by some market participants. A shale well’s so-called “decline rate” provides a profile of the pace at which a given well’s production tapers off over its life. In the remainder of this paper, we explore various elements that underpin our thesis.

Oversupply in Perspective
As a starting point, we find it helpful to place the current degree of oversupply in perspective. Simply put, somewhat lost in the discussion has been the fact that total global demand has been exceeded by a relatively small amount. Compared to the total global demand of roughly 95 million barrels of oil equivalent per day (boepd), the oversupply amounts to roughly 1–2 million boepd (Fig. 3).³ This is a relatively modest degree of oversupply, particularly for an industry where demand has steadily grown and much of the supply is located in politically unstable or environmentally harsh regions of the globe, and current prices do not appear to discount the potential for disruptions related to these factors which have historically occurred with some frequency.

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Figure 3A: World Liquid Fuels Production and Consumption Balance (Monthly)

Million Barrels per Day

100
95
90
85
80
75
70
65
60


World Production
World Consumption

Source: US EIA. There is no assurance any projection will be realized.

Figure 3B: World Liquid Fuels Production and Consumption Balance (Quarterly)

Million Barrels per Day

100
95
90
85
80
75
70
65
60

Q1'94 Q4'98 Q3'03 Q2'08 Q1'13 Q4'17E

World Production
World Consumption

Source: US EIA. There is no assurance any projection will be realized.
Some have compared the current downturn to events in the mid-1980s, which was a time when production capacity significantly exceeded demand, but available capacity today is only marginally above demand and leaves little room to make up for disruptions, stronger demand growth or steeper production declines should they occur.

Also largely overlooked has been the fact that, stoked by low prices and pockets of economic strength, total global oil demand has been growing fairly consistently. In fact, despite a fairly poor macroeconomic backdrop with Europe in recession and Chinese economic growth slowing, demand growth for oil still increased by around 0.8 mm boepd in 2014. This is in sharp contrast to the 1980s when demand fell by 6.3 mm boepd between 1979 and 1983. While we are not expecting disruptions to supply, this relatively modest degree of oversupply coupled with growing demand does suggest the potential for a sudden change in the status quo is larger than is currently being discounted by energy market participants.

Real-World Breakeven Prices Are Higher than Generally Assumed
One factor that pundits have focused on to bolster their argument for lower prices is the low cost to produce OPEC oil relative to other sources. The argument goes that with the price of oil still exceeding the cost of production for most OPEC producers, there is no pressure for the cartel to change their strategy. This line of reasoning fails to take into account that all of the OPEC producers are national oil companies (NOCs) that are wholly or partially owned by a state that depends on profits from these entities to finance government expenditures. As a result, the practical price required by these producers to achieve fiscal sustainability is far higher than current market prices (Fig. 4).

Absent higher prices, these states face an unappealing set of choices: social spending could decline, fiscal deficits could balloon, spending to maintain production could be curtailed or some combination of the three could occur. A meaningful decline in social spending, particularly if it occurs in the context of a repressive regime, brings a different set of problems with potential consequences for political stability and/or future production levels.

Some states, such as the Kingdom of Saudi Arabia, do have some amount of flexibility to draw down reserves or increase debt. However, others, such as Venezuela, Nigeria, Angola or Iraq, face far more difficult fiscal or political situations with no obvious alternatives. While the degree of resulting pain may differ, in none of these cases does the current situation appear to be either desirable or tenable longer term. The recent Saudi decision to issue sovereign debt for the first time in many years while trimming their budget deficit through reductions in fuel, electricity and water-linked subsidies are illustrative of this point.

The strength of the US dollar in recent years has only added to the strain faced by these commodity-dependent economies and their governments (Fig. 5). With the currencies of many of these energy producing countries falling relative to the US dollar, imports of crucial goods and services have become more expensive. While production and price impact decisions remain paramount, such complications have helped to fuel growing internal strife within OPEC in recent months.

Figure 4: Fiscal Breakeven Oil Prices 2015 (Estimates)

<table>
<thead>
<tr>
<th>Country</th>
<th>Oil Price (Estimates)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yemen*</td>
<td>$314.00</td>
</tr>
<tr>
<td>Libya</td>
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</tr>
<tr>
<td>Bahrain</td>
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<tr>
<td>United Arab Emirates</td>
<td>$72.57</td>
</tr>
<tr>
<td>Qatar</td>
<td>$55.51</td>
</tr>
<tr>
<td>Kuwait</td>
<td>$49.07</td>
</tr>
</tbody>
</table>

*Yemen was a net oil importer in 2015.

Source: International Monetary Fund, Regional Economic Outlook: Middle East and Central Asia, October 2015. There is no assurance any estimate will be realized.
The Shale Oil Industry Faces a Host of Challenges

Shale oil producers also face a set of challenges resulting from a prolonged period of depressed prices that will have an impact on future production levels. An initial increase in overall shale production levels since the period marking the start of the decline in oil prices may have led some to erroneously conclude that the US shale industry has somehow managed to defy conventional laws of economics (and physics). Instead, we believe these challenges have just been masked by a range of factors we will discuss in more detail. When these factors are taken into account, we believe shale oil’s surprising rise is more fragile than appears at first glance.

Although the production from all oil wells tends to decline with time, shale wells typically generate the bulk of their output within their first few years, unlike conventional oil wells that can produce at higher levels for many years as more of the original oil in place is extracted. This steep decline rate dictates that a steady stream of additional investment in drilling and production is necessary in order to maintain, let alone grow, production levels. This is different from the 1980s when typical production was coming from slower declining reservoirs.

With borrowing rates low and energy prices high, financiers were eager for the opportunity to lend money to borrowers willing to post collateral that consisted of tangible, liquid assets. As the price of oil has declined, that willingness has also subsided as illustrated by a significant decline in the prices of energy sector bonds across the credit quality spectrum. However, the borrowing base redetermination process (which takes place twice a year and determines the amount of capital available for additional drilling and exploration from bank lines) has been largely benign so far as lenders have been wary of the larger implications of an abrupt reduction in available funds. At current prices, however, it is likely that all but the very best shale wells (the so-called “sweet spots”) are no longer economically viable, as demonstrated by the significant write-downs in asset values over the past several months. That, in turn with bank-determined valuations, will likely result in a large decrease in the amount of collateral available to secure lending. Consequently, we think the longer the rout continues the more lenders are likely to draw in their horns, which means less capital available for drilling and development activity (Fig. 6).

PERSPECTIVE: FRANKLIN TEMPLETON FIXED INCOME GROUP

Despite the declines we have seen so far in energy prices, there has been no change to our focus within the high-yield component of our portfolios. We continue to favor the exploration and production sub-sector as, in general, these companies control oil and natural gas reserves and we believe price levels for many of these issues reflect an overly pessimistic oil price outlook. We therefore find the risk/return profile for many of these issuers attractive. Over the intermediate term, we expect oil prices to move higher from recent levels, which could provide support to bond prices for many energy issuers even as certain companies are forced or look to opportunistically restructure and de-lever their balance sheets in the interim. While we expect prices to remain volatile in the near term, we believe we are potentially well positioned for an eventual recovery in oil prices.

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In a logical quest to limit the effect of reduced capital spending on long-term cash flow, shale oil producers have pursued a number of financial and operational tactics designed to sustain production levels. These tactics are likely not sustainable for an extended period of time. First, they have focused incremental capital expenditure on the development of their inventory of sweet spots. By definition, however, the number of such wells is limited and, once exhausted, will likely be replaced by higher cost options. A second tactic adopted by shale oil producers has been to hedge future production when market prices tick up as they did early-to-mid 2015. Such a decision can cushion the blow from lower prices but not eliminate it entirely as most higher-priced hedges terminate in 2016.

Shale producers have also pressed hard to gain large pricing concessions from oilfield service (OFS) companies even as utilization rates and consumption of products has fallen off. The resulting effect has been dramatic in terms of the decline in employment and profitability as the OFS industry has struggled to manage through both reduced volumes and declining profitability. Many oilfield service providers are currently operating at a loss and minimizing reinvestment in their business, which could have long-term implications related to producers’ ability to respond to supply shortages. In 2015, we witnessed a 25% reduction in overall energy-related capital spending (although higher in the United States) and some analysts think we could see a further reduction of at least 20% in 2016 (Fig. 7). One of two eventual outcomes seems likely. The first is that prices recover over the near term and OFS firms seek to recover what they conceded during the downturn. The second is that prices remain low and OFS industry capacity declines to the point where firms eventually regain some control over pricing. In either case, the unsustainability of the status quo will likely lead to upward pressure on oil prices.

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 Longer-Term Growth Hampered by Declining Production Levels 

Given the focus on increased global oil supply, the casual observer could be forgiven for failing to note that during the 10-year period ending in 2014, non-OPEC oil production, excluding the former Soviet Union states and US shale, largely failed to grow despite an average price of about $80 per barrel over that time.

We think that the implications of this have gone largely unappreciated: In order for global oil production to continue to grow, the industry must find and develop new sources of oil to overcome the decline in production from legacy resources—a task that has historically been difficult. One reason for the current lack of visibility is the fact that, for the first time, the excess supply of oil has been caused by a resource with very high depletion rates—a dynamic for which there is no precedent. This steep decline rate will likely be exacerbated by the sharp reduction in spending by shale oil producers (Fig. 8).

The early years of the current century saw a slew of large international oil company (IOC) mergers. One reason for these combinations was the ability to fund the massive capital expenditures and underwrite the risk inherent in the process of finding and developing meaningful additions to their conventional oil reserves. After a decade or more of intense but largely fruitless activity, IOCs have begun to scale back their ambitions in

PERSPECTIVE: FRANKLIN LOCAL ASSET MANAGEMENT – MENA EQUITIES

Looking at equity markets in the MENA region, the decline in 2015 was largely in line with other emerging markets and far less than the fall in energy prices. The intensified pullback in MENA equities in early 2016, however, has driven down valuations to an extent that many stocks are priced for negligible growth, which we think is neither realistic nor likely. Importantly, energy-related stocks and sectors comprise less than 2% of the stock market, which indicates the breadth of the market and its relatively low dependence on oil price movements, a result of the government’s direct ownership of the region’s oil assets. As a consequence, consensus corporate earnings growth projections for the region remain stubbornly high, at a robust 14%* rate in 2016, which is more than double the 6.5%** corporate earnings growth forecasted for emerging markets. Our own internal earnings growth projections, while healthy, remain more conservative than consensus.

Bassel Khatoun 
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Franklin Local Asset Management – MENA

*Source: Based on consensus estimates from Bloomberg as of 1/5/16. MENA average calculated as market capitalization-based weighted average of the constituent countries.

**Source: MSCI Emerging Markets Index data on Bloomberg as of 1/5/16.
response to declining cash flow and shareholder concerns, at least for the time being which is likely to eventually impact non-OPEC production levels (Fig. 9).

The advent of shale oil has not addressed the fundamental challenge either. As discussed in the previous section, shale well production drops sharply in a relatively short span of time as a result of steep decline rates. This is largely due to the fact that shale or tight rocks have poor flow characteristics, so most of the oil and natural gas is liberated with the initial fracking of the well as opposed to conventional resources that have better natural flow characteristics that drain a larger area. While the effect can and has been ameliorated to some degree by improvements in technology, rapid depletion means the reserves and production cannot grow without a constantly increasing stream of additional investment to bring new wells online. As also discussed in the prior section, such additional investment is more sensitive to short- to intermediate-term changes in energy prices than conventional, longer-cycle investments and seems unlikely to occur should prices stay at their current levels.

**Conclusion**

While the global oil market’s current oversupplied status is genuine, we believe that the steady drumbeat of negative headlines has obscured important details about the situation and that the bearish status quo is far more fragile than suggested by many experts. At current prices, both OPEC and shale producers face a situation that is unsustainable over the longer term. Moreover, pressures are already building that suggest the rebalancing process has already begun although mostly in ways that have gone largely unnoticed. As a result, from a contrarian standpoint we believe the potential for a modest rebound from current levels is far greater than many have suggested and that current levels of risk and reward look attractive for patient investors.

Factors key to our assessment include (1) The current oversupply of oil is a relatively small amount; (2) While the price of oil still exceeds the cost of production for most OPEC producers, the practical price required by these producers to achieve fiscal sustainability is far higher than current market prices; (3) Shale oil’s steep decline rate in production requires additional investment in order to maintain, let alone grow, production levels, and current oil prices have made necessary financing increasingly difficult to attain; and (4) Longer-term supply growth requires the historically difficult task of finding and developing new sources of oil to overcome the decline in production from legacy resources.
WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. Investing in the natural resources sector involves special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector—the prices of such securities can be volatile, particularly over the short term.

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6. Source: US Energy Information Administration; Cushing, OK WTI Spot Price FOB; as of 2/24/16.

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