WILSONS

Oil: Heating up, while no one is watching

Our weekly view on Australian Equities

17 June 2021

2019 oil demand levels within sight

Oil prices are up +300% since bottoming in mid-2020, as global markets saw demand fall by over 20% in response to worldwide activity restrictions. As the world has gradually emerged from the grips of COVID-19, oil demand has recovered, with most major oil agencies now suggesting that oil demand will equal 2019 levels by early 2022.

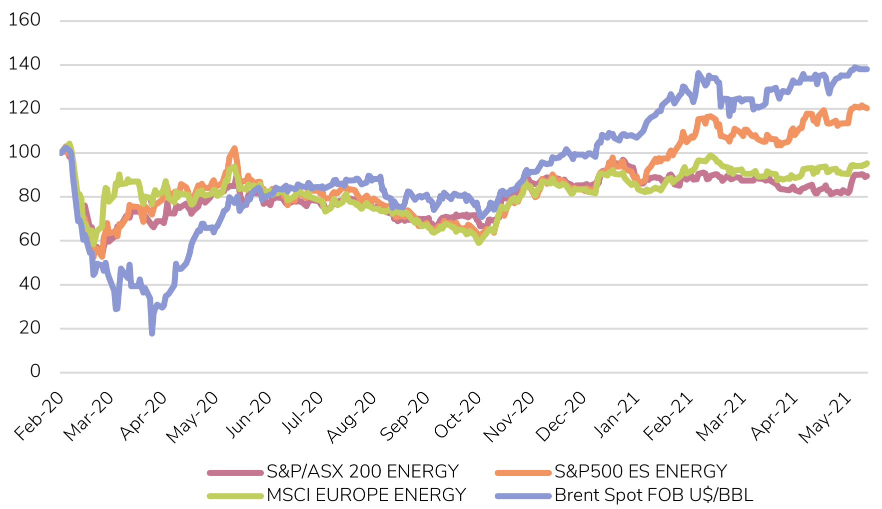
The market is not only underestimating the demand side of the equation, but is significantly underestimating the supply side. Global CAPEX budgets of oil companies were suppressed as cash preservation became a priority during COVID-19. This will impact the growth of replacement supply in the coming years, setting up the distinct prospect of an oil price squeeze.

Rising Environmental Social & Governance (ESG) concerns add another layer of complexity and extends the timeframe of bringing new oil supply online. In our view, the oil price is only one crisis away from surging.

Oil-related equities have performed strongly over the last 9 months, but have still underperformed the moves in the underlying oil price, despite the inherent operating leverage of energy producers.

The Australian energy sector has lagged the oil price more than global energy equities. From a valuation perspective, this leaves Australian Energy equities trading at a historically wide discount relative to the market, which we think is unsustainable. The Wilsons Australian Equity Focus List is overweight the Energy Sector with exposures to **Santos (STO)** and **Worley (WOR).**

Exhibit 1: Australian energy equities have dramatically underperformed the recovery in the oil price



Source: Refinitiv, Wilsons

Oil market fundamentals

In a normal operating environment, the world needs 100mb/d to satisfy demand. Global oil demand fell to an annualised rate of 90mb/d during 2Q20. OPEC currently estimates global demand to be ~95mb/d at the end of June, still almost 5mb/d short of 2019 levels. With economic activity restrictions still in place, particularly in energy consumptive emerging markets and transport/airline travel in developed markets, we are becoming increasingly bullish around the prospect of oil prices breaking out to the upside.

OPEC+ (~30% of global supply) actions in restarting suspended production appear measured and proportionate with rising demand. OPEC+ seems to be comfortable with 'managing' the oil price to maximise value (not volume) amongst member nations. Of course, as oil demand rebuilds, the risk of OPEC flooding the market with oil and impacting prices reduces.

A further telling sign that oil demand is improving is the run-down in global inventories, which have fallen 15% from the 2020 highs and are now almost in line with 2017-2019 levels.

It remains very difficult, in our view, for the world to supply more than 100mb/d per day. More OPEC+ supply and restarting suspended production can help restart the missing 5mb/d as activity normalises, but a sustainable increase in oil supply above 100mb/d is difficult. Even with spot oil prices or an effective incentive price of Brent crude currently at $US75/bbl, the ability to start large scale new projects is also challenging.

The ability of non-OPEC+ to grow production over the medium-term is significantly constrained. As a consequence, the risk of the structural deficit in oil supply is increasing.

Many of the reasons for the lack of non-OPEC+ supply growth were in existence pre-COVID-19, particularly US shale which had chronic supply disappointments in recent years. The dramatic fall in global oil exploration CAPEX due to COVID-19, now equating to a full year of lost spend, will have a lasting impact on oil markets over the medium-term. The oil market, is not pricing in this risk at present.

Nowhere is this mismatch more visible than in market consensus forecasts for Brent crude. We think the market is being complacent around the emerging structural deficit in oil markets with short-medium term price forecasts in line with long-term prices in the $US60-65/bbl range. Both forecasts are currently below spot prices of Brent. In futures markets, forward oil prices are in backwardation, which again suggests that oil market participants are complacent.

We think the relative calm we are seeing in oil markets today is only momentary. It would not take much of a crisis to see oil prices surge through $US80/bbl. That crisis could be a large pipeline outage, severe weather event, significant supply disruption or geopolitical instability in key oil-producing nations.

Demand destruction will not provide an offset in the medium term

The shift away from carbon-intensive energy use will matter a lot as we approach the end of the decade.

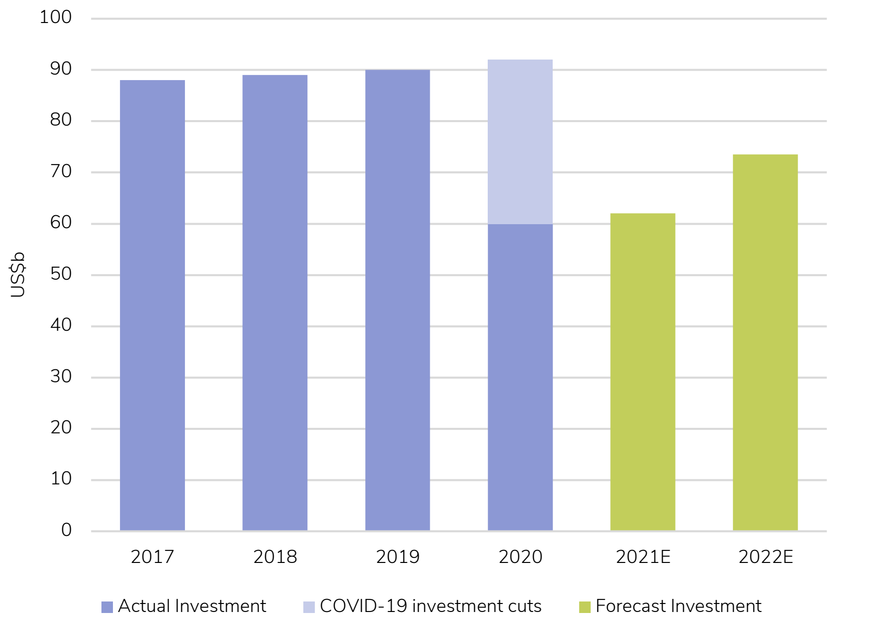
Oil demand destruction from clean energy is a real and serious threat to oil demand in the long term.

But in the short-medium term, no amount of policy pivot or redirection of capital spending will hasten the speed at which the world can pivot away from oil. Even the most optimistic forecasts for EV penetration have 50% of new vehicle sales by 2030, which still leaves ~90% of the world's vehicle fleet being powered by fossil fuels.

See: [Electric vehicles energizing the lithium outlook]

There is a real risk that the increased ESG pivot into clean energy will result in both underinvestment in oil supply and longer time frames for new production to be bought online. With oil demand relatively inelastic (outside of a pandemic), oil price risks are skewed to the upside over 2022-2025. In our view, the potential for a further rally in the Energy sector is simply a matter of when, not if.

Exhibit 2: Global oil exploration capex budgets have seen a dramatic fall since 2020



Source: IEA, Wilsons

Exhibit 3: Market forecasts for oil look complacent given our view on the supply/demand outlook*

*Source: Refinitiv, Wilsons. *Wilsons aggregation of consensus forecasts.*

Oil prices and equities

In the last oil price rally between 2016-2018, where oil prices rallied almost 2x, the Australian Energy sector largely kept pace with the oil price. During this time the three largest Australian oil producers – **Woodside (WPL), Santos (STO) and Oil Search (OSH)** – were all going through periods of strong prospective project growth from the North West Shelf; Gladstone and LNG were being commissioned; and increased cash generation in the eyes of investors was imminent. Growth was seen as a certainty, not an option.

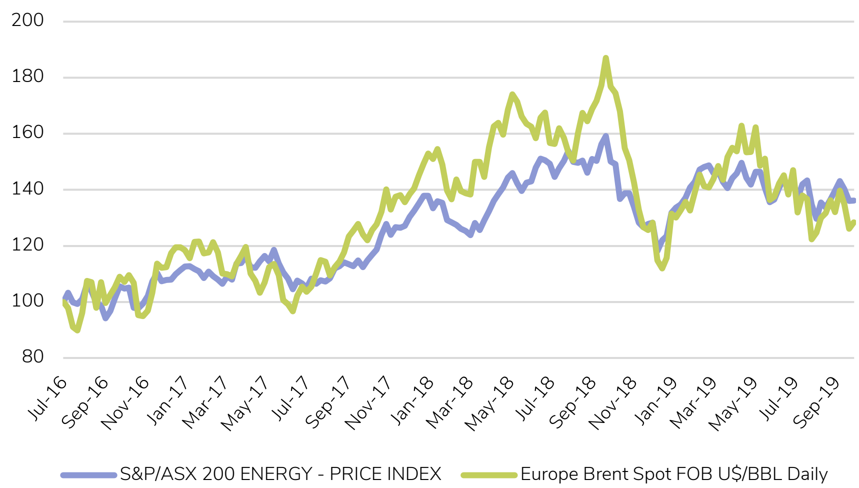
Australian energy underperformance versus global

Australian energy stocks have dramatically underperformed US peers and European peers in this oil price cycle, despite our proximity to Asia and the emerging market story.

We think part of the reason for this is that relative production growth rates have reversed. Global energy companies are now offering higher prospective growth vs. Australian equities.

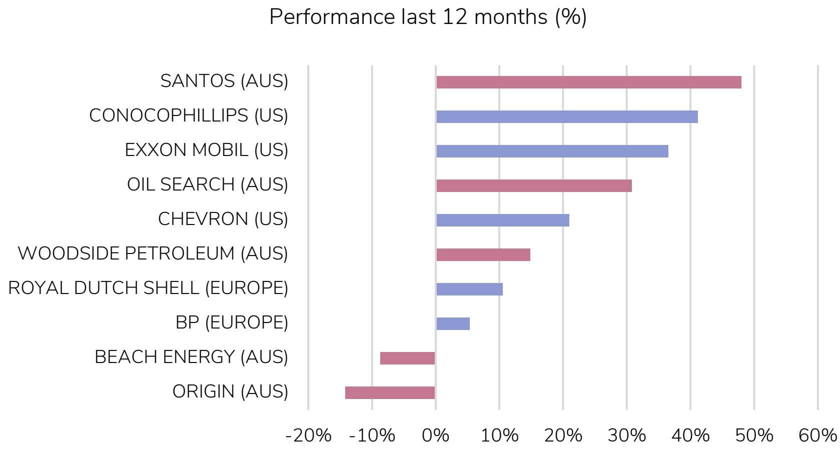
As a consequence of the relative underperformance, Australian equities are now trading at the widest discount to the market that we have seen in over a decade (ex-March 2020). On a PE relative basis, the sector is at a 25% discount to its long-term average and a 50% discount when the sector last had the benefit of rising oil price.

Exhibit 4: Australian oil equities kept up the oil price during the 2015-2018 rally



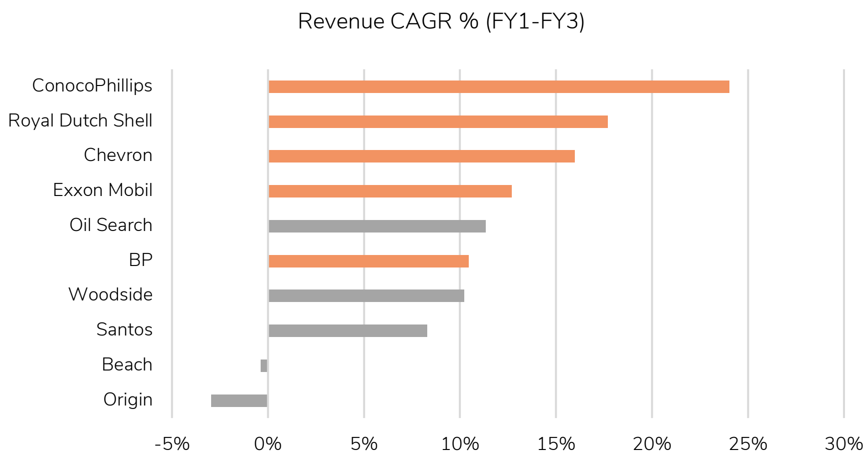
Source: Refinitiv, Wilsons.

Exhibit 5: Most Australian energy companies have underperformed global energy



Source: IEA, Wilsons

Exhibit 6: Unusually, Australian Energy stocks have lower production growth over next three years*



*Source: Refinitiv, Wilsons. *we have used revenue growth as a proxy for production growth.*

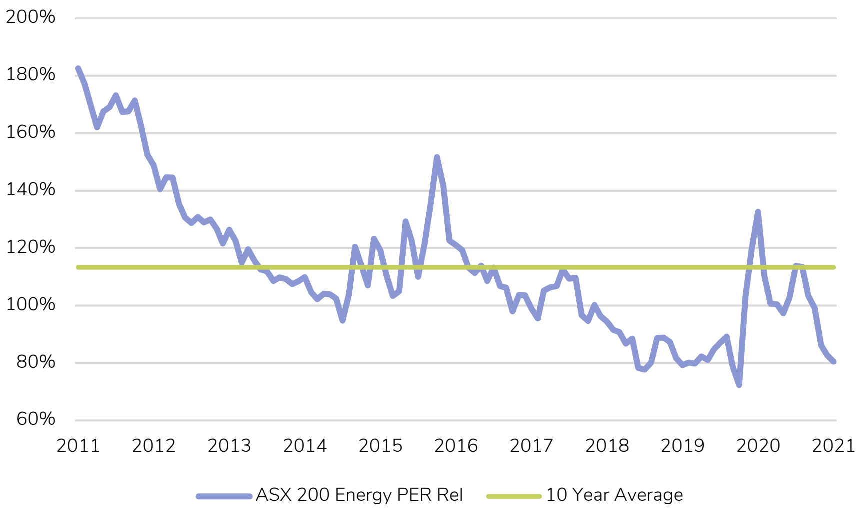
This discount may not all be explained by the markets subdued view on the cyclical aspects of the oil price and lower growth prospects. Part of the discount may be due to perceived structural/ESG concerns – particularly fossil fuel derived income.

The energy sector is not alone, we see similar discounts currently in companies like **APA Group (APA), AGL Energy (AGL), Aurizon (AZJ)** and **Origin (ORG),** all of which earn a significant proportion of the income of fossil fuel-related activity.

It's not clear in our view, that this is a permanent discount, but it does appear that Australian carbon-intensive companies have a larger "ESG discount" applied to them at present than offset companies.

We question whether this discount would be sustainable if oil prices were to move dramatically higher – something we are increasingly becoming more bullish on.

Exhibit 7: A higher oil price should close the Energy index's PER discount to its historical average



Source: Refinitiv, Wilsons.

Focus List exposure

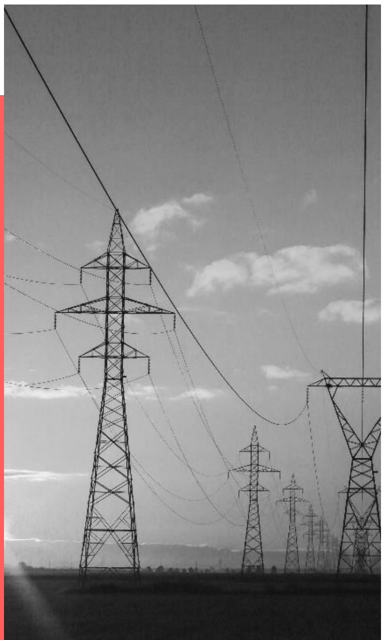
Our high conviction call on energy remains our largest commodity-specific active weight at 2.5x index within the Focus List. **STO** and **WOR** are all positively exposed to higher oil prices. For more on the Focus List positioning see our report.

Share prices of Australian energy producers are currently implying a Brent oil price of $US55-60/bbl, a discount to the spot price of $US74/bbl. If oil prices stay at $US74/bbl over the medium term, we think the market will need to upgrade valuations of energy producers by 20-40%.

We believe that higher prices into 2022 will drive a new round of "catch-up" spending across upstream projects, which could send WOR earnings +50% higher within 3 years.

STO's long-term production growth is sector leading, and while this has seen STO deliver the strongest price performance over the last 12 months, we think parts of the market still believe STO's production growth will require additional equity capital. We disagree with this view and think STO will be successful with asset sell downs which will maximise the value of Santos.

Both stocks should benefit if the oil market is squeezed higher over the next 12-18 months.



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Recommendation structure and other definitions

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Wilsons contact

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com