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WHY OIL WON'T BREACH $70 FOR 5 YEARS – AND WHAT THIS MEANS FOR INVESTORS

By Esther Armstrong, BNY Mellon IM EMEA

While the outlook for the price of oil is bleak, portfolio manager at The Boston Company[1] Robin Wehbé says the sector still offers investors opportunities.

The response of oil and gas companies to the dramatic price reduction of 'black gold' over the past year means the commodity is unlikely to break out of the US$60 to US$70 per barrel range over the next five years, says The Boston Company Asset Management (TBCAM).

In the summer of 2014 a crucial tipping point was hit chiefly due to ramped up US oil production through fracking. This skewed the traditional supply and demand dynamic to one of oversupply, explains Robin Wehbé, portfolio manager at the US-based BNY Mellon boutique.

"No other country had delivered such meaningful growth in recent years, placing the US as a central player for incremental crude production," he adds.

Oil and gas producers reacted to this shift by trying to reduce their cost footprints through lowering overheads, cutting staff and pursuing acquisitions to give them greater scale for synergies. This in turn has created something of a self-perpetuating cycle and Wehbé believes it may have inherently lowered the industry's cost curve and the theoretical 'breakeven' price for oil.

"So what changed the game? In a word, fracking. This technology has spurred the North American energy revolution, unleashing surprisingly abundant energy resources from unconventional resources. Oil supply has moved to a 'just-in-time' supply chain, suggesting the pullback in oil prices is structural and prior highs above US$100 a barrel are increasingly less relevant."

Cost of production

Wehbé says there are two main components that go into the cost curve for oil (the base price necessary for an oil producer to make a profit): the cost for finding the oil and that for getting it out of the ground.

Before 2015, the cost of exploration, developing and extracting oil added up to some US$30 per barrel, he says. But, he adds, there are other extras that also need to be factored into the price, such as required margins and transportation costs. All in the breakeven point for oil production companies pre-2015 was around US$47, Wehbé says. "This means at US$70 a barrel companies were able to earn a 15% return and still have a cash margin of US$2.15."

Today, post company cutbacks and lower transportation costs (a result of more pipelines), Wehbé believes different assumptions must be made to work out the breakeven cost per barrel for oil companies. He thinks a more realistic figure today is closer to US$35 per barrel. "Even with oil as low as US$52 a barrel, companies are able to generate the same returns and thus grow supply."

[1] BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA) is the distributor of the capabilities of its investment managers in Europe, Middle East, Africa and Latin America. Investment managers are appointed by BNYMIM EMEA or affiliated fund operating companies to undertake portfolio management services in respect of the products and services provided by BNYMIM EMEA or the fund operating companies. These products and services are governed by bilateral contracts entered into by BNYMIM EMEA and its clients or by the Prospectus and associated documents related to the funds.

Given these estimates Wehbé thinks the industry will continue to be able to absorb lower oil prices, supported by deflationary cost pressures, and as a result believes oil prices could remain under a US$70 ceiling for some time to come, if not indefinitely.

Investment implications

The implication of this shift is that investors must be more discerning about investing in the sector. Previously, investing in exploration and production companies was viewed as a way to reap the benefit of the margins between a firm's 'breakeven' costs and the rising commodity price, according to Wehbé, and this is no longer a viable strategy. Companies will no longer be able to grow simply through relying on higher prices, he says.

The knock-on effect of this change will be intense competition between companies in the sector and Wehbé predicts exploration and production companies will advance any project over their individual cost of capital with little regard to the impact this could have on the industry as a whole and longer-term oil prices.

As such, Wehbé views better risk/reward opportunities in companies that benefit from higher oil volumes more so than price, such as equipment and service suppliers, pipes and transportation, and some downstream refining and chemical companies.

"The industry continues to be service- and capital-intensive and the commodity will always need to get to market. This means we are seeing greater value opportunities in the services segment of the sector," says Wehbé.

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