FOCUS ON OIL

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U.S. SHALE: THE SAVIOUR AND THE SCOURGE OF THE OIL MARKET

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"With oil prices tumbling by over 60% since mid-2014, sentiment towards oil equities is clearly negative and the sector is out of favour. While there is a high degree of uncertainty on the direction of oil prices in the short-term, the market is expected to move from an oversupplied to a more balanced position within the next 12 months."

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The following note gives the views of the team at the time of publication.

HIGHLIGHTS

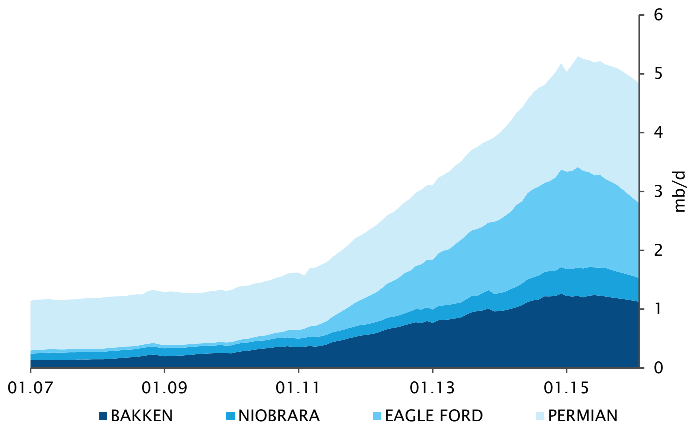
— Oil prices have tumbled by over 60% and have remained weak, primarily because of the resilience of U.S. tight oil production.

— Today's lack of investment is tomorrow's undersupply and prices will recover. However, timing is uncertain as there are several oil price headwinds that can keep oil prices depressed for a prolonged period.

— To protect against this scenario, it is important to invest in companies that have the ability to withstand such an environment with the following attributes: low cost production; low geopolitical risk; and solid balance sheets.

The stars were aligned for U.S. shale between 2011 and mid-2014 as the global oil market witnessed a period of stable and high prices with crude averaging over USD 110/bbl. During this phase, geopolitical turbulence in Libya, Iraq and Iran led to reduced exports which created a market supply shortage. U.S. tight oil came to the rescue and plugged the gap thanks to technological advances in horizontal funding techniques, and funded by an 'expensive' oil price and cheap credit. Spectacular production growth ensued, and U.S. shale production rose to over 4.5 mb/d, or nearly 5% of global crude demand.

Oil Production of Selected US Shale Plays

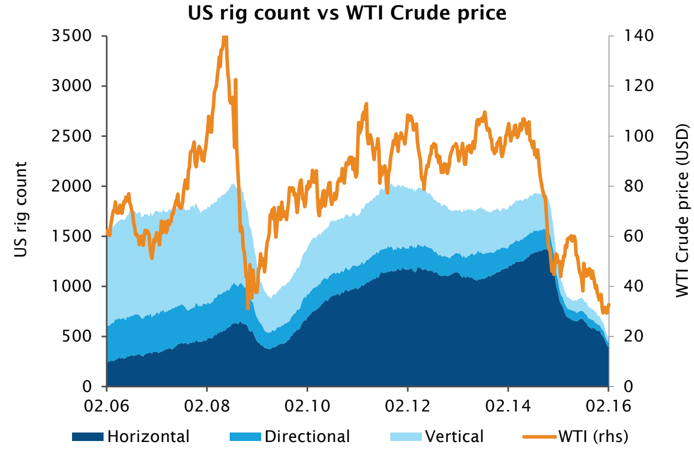


Source: Datastream, SYZ AM. Data as at 31.01.2016

Shale production has remained resilient in the face of weak oil prices.

Saudi Arabia's decision to relinquish its role of OPEC market guardian and 'turn on the taps', combined with the return of supply from Iraq, forced a first oil price decline ending in late-2014. Subsequently, the U.S. rig count (which has historically correlated strongly with shale oil production volumes) collapsed, although shale volumes have only declined moderately. Shale's resilience, coupled with the lifting of sanctions on Iran has led to a global supply glut and a further decline in oil prices and 12-year lows of USD 26/bbl have recently been tested.

US rig count vs WTI Crude price



Source: Datastream, SYZ AM. Data as at 31.12.2015

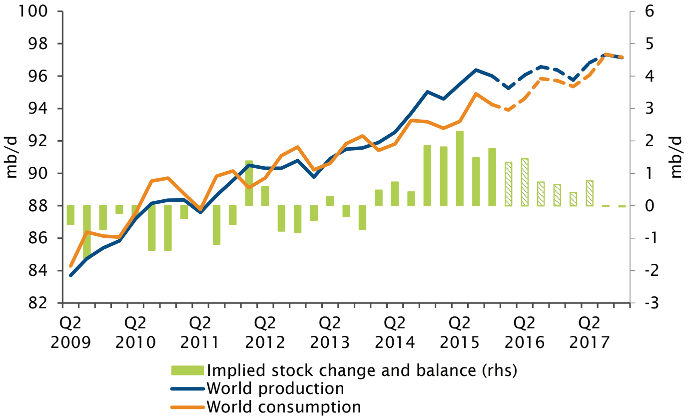
Record inventory levels and shale resilience now act as major oil price headwinds.

The global supply glut has led to record global inventory levels of between 1.5 to 2 mb/d. With Saudi's decision to pursue a volume based strategy (it previously had over 80% of global spare capacity), U.S. shale is now considered to be the only true variable source of supply given its ability to quickly adjust production as required to balance the market. However, to the scourge of the global oil market, U.S. shale output has remained resilient as operators are 'cherry-picking' their most productive acreage and the industry has managed to significantly reduce per well costs, speed-up cycle times, and advance well productivity through a mix of technical innovation and the efficiencies associated with repeating a 'manufacturing' process.

Further oil price falls may be required to balance the market.

Although the sharp deterioration in the financial condition of U.S. exploration & production companies is likely to persist given lower oil prices and reduced access to credit, the rebalancing of supply and demand is proving much more difficult than anticipated. If volume reductions through U.S. E&P bankruptcies are insufficient, there is the risk that production cuts take place too slowly, or not at all. This could lead to a scenario in the short-term where prices collapse to cash cost levels, which forces supply off the market, causing it to clear as it has historically.

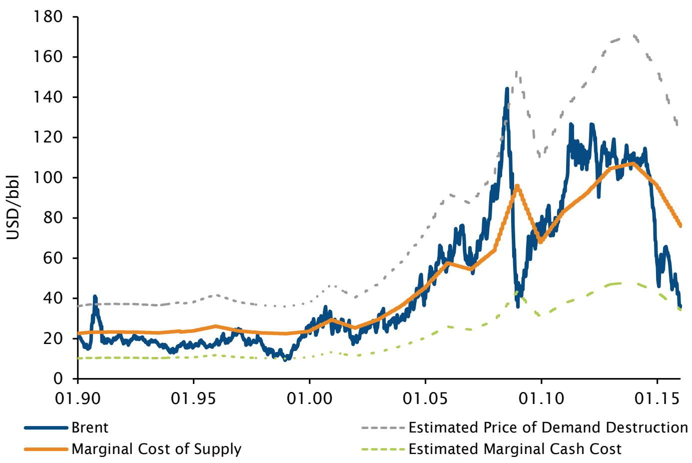
World Liquid Fuels Production and Consumption Balance



Source: Datastream, SYZ AM. Data as at 01.02.2016

The industry will require higher prices to sustain itself longer-term.

The price of oil tends to oscillate between supply surplus, where cash costs determine a price floor (currently below USD 25/bbl) and the price at which demand destruction sets in (c. USD 120/bbl). While prices can overshoot this range, over the long run they will trend in line with the marginal cost of production, or the minimum price required for the upstream industry to sustain itself. This has fallen recently as lower oil prices have led to structural and cyclical cost deflation across the supply chain. Following Saudi's decision to pursue market share, global spare capacity has fallen to below 5% of demand, which is close to historically low levels. This suggests that oil prices will rise towards the marginal cost levels and beyond once inventories have been worked through.



Source: Bernstein, Bloomberg, Factset. Data as at 31.12.2015

The oil market balance is fragile and at the whim of several unknowable tailwinds and headwinds.

The current global surplus of 1.5 to 2 mb/d represents a very narrow margin of oversupply of around 2% in the context of the 94 mb/d oil market. Highlighted in the following page are some of the relatively unpredictable factors that can cause a significant shift in the market balance and oil price relative to the current outlook.

Identifying opportunities within the European Oil Sector.

With oil prices tumbling by over 60% since mid-2014, sentiment towards oil equities is clearly negative and the sector is out of favour. While there is a high degree of uncertainty on the direction of oil prices in the short-term, the market is likely to move from an oversupplied to a more balanced position within 12 months. However, there remains the possibility of a prolonged period of weak oil prices. Consistent with its focus on downside risk, the European Equities team at SYZ Group is hunting for companies with resilient business models that have the ability to withstand such an environment with the following 3 main attributes, in addition to an attractive valuation:

1. ***Exposure to low cost production:*** companies with exposure at the lower-end of the oil cost curve have a sustainable competitive advantage, as they can be cash generative and remain profitable even in depressed oil price scenarios.
2. ***Low geopolitical risk exposure:*** it is wise to avoid companies with operations in some of the world's less desirable holiday destinations where geopolitical turmoil or policy change can rapidly wipe out equity value.
3. ***Solid balance sheets:*** allow companies to weather a prolonged oil price downturn and provide fire-power to take advantage of quality assets that may become available at distressed prices.

By investing in companies with these qualities, downside risk is minimised and to there is asymmetric risk to the upside when oil prices do recover. Indeed, the saying that "the cure for a low oil price is a low oil price" is likely to hold true, as today's underinvestment across the upstream industry is likely to result in tomorrow's undersupply, which sets the stage for the oil market to once again find salvation in U.S. shale.

OIL PRICE TAILWINDS		OIL PRICE HEADWINDS	
Geopolitical turmoil	In part exacerbated by low oil prices as countries struggle to balance oil-dependent budgets, can lead to supply disruptions that tighten markets quickly.	**Lower than expected demand**	With the dollar strengthening, emerging markets suffering, China slowing and gas regaining competitive strength, 2016 may not be another strong year for oil demand as anticipated.
Today's capital underinvestment is tomorrow's undersupply	Longer-term, new supply will require higher prices to incentivise investment in order to meet future demand growth and to offset legacy supply declines (around 5% p.a.). 2015-16 represents the first time upstream capex has fallen in consecutive years since 1986-87, which ultimately sets the stage for a supply crunch.	**Higher than expected supply increases**	With Iran or Libya in particular surprising to the upside. Iran's return to the market could see an additional 1 mb/d hit the market, with potential opening to foreign investment exacerbating this.
OPEC to the rescue?	Arguably OPEC (Saudi) could reverse its volume led-strategy to alleviate fiscal pressure. However, by doing so they would bail out some of the U.S. shale producers they are trying to undermine.	**Subsidy removal**	Petroleum subsidies in developing markets are increasingly at risk of being scaled back amidst low oil prices. Were subsidies to be halved, this could lead to 3 mb/d of demand downside.
		A technological breakthrough	Leading oil to lose its monopoly transportation fuel status in a more environmentally sensitive world. Transport related oil demand could be decimated to the extent of the time it takes for the global vehicle fleet to switch to an alternative energy source.
		Vehicle fuel efficiency	Standards continue to be enacted around the world. Under the assumption that new car efficiency improves at 3% p.a., and that overall fleet efficiency grows by 2% by the end of the decade (IEA expects 2.5%), this represents an annual saving of >0.7 mb/d, as road transport accounts for 36 mb/d of oil demand.

Source: SYZ AM.