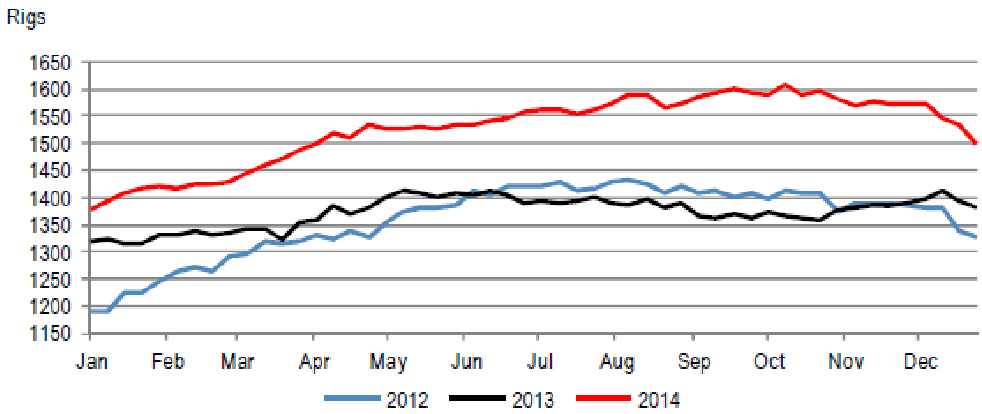
Oil & Gas Sector Update

Oil prices have extended their downward slide in January, after declining approximately 50 percent in 2014, with the WTI Futures currently trading at US$47.93. The same reasons continue to be the core drivers: global oversupply and subdued demand. Not surprisingly Australian oil equities – Santos, Oil Search, Woodside and Origin Energy – took a significant hit to their share prices, after a brief respite towards the end of 2014.

Ongoing commentary from the Middle East oil producers suggest there is little hope of getting a cut to their output in order to restore the supply and demand equation. Iraq and Russia continue to increase their supply, with Qatar estimating the current oil surplus to be around 2 million barrels per day. While in the short term bearish news continues to dominant oil markets, long term we continue to see oil prices reverting back to long-run marginal cost of supply – approximately US$85 per barrel.

US (Non-OPEC) Production. Among the main drivers of the oversupply in global oil prices has been the significant increase in production out of the US, on the back of the unconventional shale oil revolution. On average the US oil producers are higher up the supply cost curve versus their Middle East counterparts and on average require oil prices to be around US$90 per barrel to be viable. The lower oil prices are starting to impact new exploration activity in the US. We are seeing the US crude oil rig counts declining in recent months, indicating oil producers are putting exploration activity on hold in the current environment. This is a positive sign, but it is no silver bullet for oil markets. Given US crude oil output looks set to remain at 1 million barrels per day for 2015 due to a combination of wells already drilled, inventory, and hedging programs put in place prior to the big crude price fall in 2014.

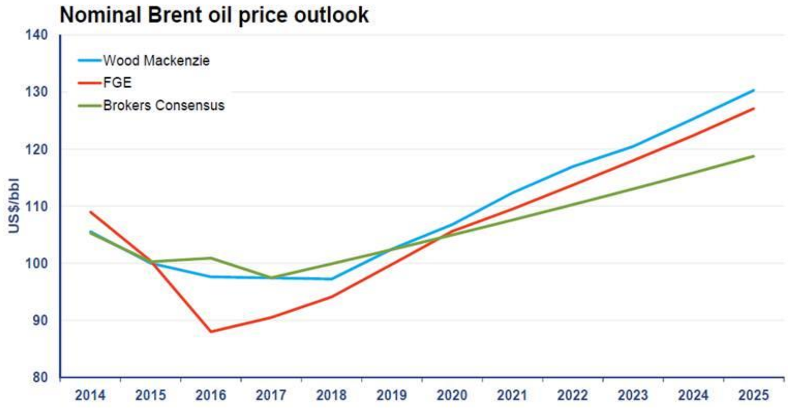


Source: Baker Hughes,

OPEC Production. Saudi Arabia, the largest OPEC producer, has been quoted as saying that it will keep a "solid will" despite falling oil prices. We have noted in the past that some supply can be removed from oil markets if all OPEC members adhered to the set target of 30 million barrels per day. It was reported that OPEC, which consists of 12 members and supply 40 percent of global oil, exceeded this target for a 7th consecutive month by producing 30.24 million barrels per day in December 2014.

Flow on effects of lower oil prices. While oil producers are feeling the pinch, the flip side of lower oil prices is the positive impact it has on consumers globally. Lower share of wallet on fuel means consumers have increased propensity to spend on consumption, which also has a flow on impact on consumer sentiment. All positive for businesses and consumers, which in turn could actually increase demand. For example, in Australia lower oil prices could have a positive impact in the range of 1% to 1.5% on GDP. Similar numbers can also be said of China, Japan and Europe. Further, it also reduces the pressure on inflation, which will likely see rates remain accommodative.

Spot Price vs. forward price curve. Along with consensus, we have reduced our forward oil price expectation in our free cash flow forecasts. However we note it still remains well above the current spot price. In our view, which is in line with consensus, that while the short term price (spot price) may continue to be weak for a period of time, it is expected to rebound to the global average marginal cost of supply of approximately US$85 per barrel. If we were to run through the current spot price of oil and FX into perpetuity for our Australian oil equities, we would likely see: the equity value of Santos become worthless; Oil Search equity value to drop by approximately 50% from current levels; Woodside equity value to drop by approximately 40%; and Origin Energy equity value to drop by approximately 35%. The graph below indicates that most industry participants (including oil companies, industry consultants and investors) expect oil price recovery above the US$90/b. However, this adjustment is likely to be more prolonged if irrational behaviour dominates.



Source: Oil Search Presentation

Energy Equities. Not surprisingly Australian oil equities – Santos, Oil Search, Woodside and Origin Energy – have taken a significant hit to their share prices. In the current environment, investor focus has turned to balance sheets, capital expenditure plans and the viability of current projects. Most companies have already responded to the lower oil prices by tightening their capital expenditure and taking costs out where possible. This leaves balance sheet as the key focus. Within our universe Santos stands out as the only candidate which could potentially have balance sheet issues. Ratings agency S&P downgraded its 2015 and 2016 Brent oil deck to US$70/75/bbl, the third downgrade in less than two months, having downgraded Santos' corporate rating from BBB+ to BBB earlier that month. Given further falls in oil prices since those downgrades, the risk is that S&P moves again on either its oil price deck or Santos' credit rating. At spot oil and foreign exchange, we estimate Santos could struggle to hit a 20% funds from operations to gross debt ratio by the end of 2016, even if it underwrites its DRP and is successful in issuing a €1 billion hybrid. S&P noted in its downgrade of the Santos rating on 8 December that the BBB rating could be at risk is Brent oil prices were sustained at less than US$75/bbl over the next three years and the Australian dollar averages greater than US$0.85. S&P's new oil deck implies an average of US$77/bbl over 2015–17 and its currency outlook is US$0.80. Having already slashed its 2015 capital expenditure budget by $700 million, Santos is running out of time and options to navigate its way through its balance sheet squeeze. We do not rule out a potential capital raising as a means for the company to further shore up the balance sheet.

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