MARCH 2020

Oil Update

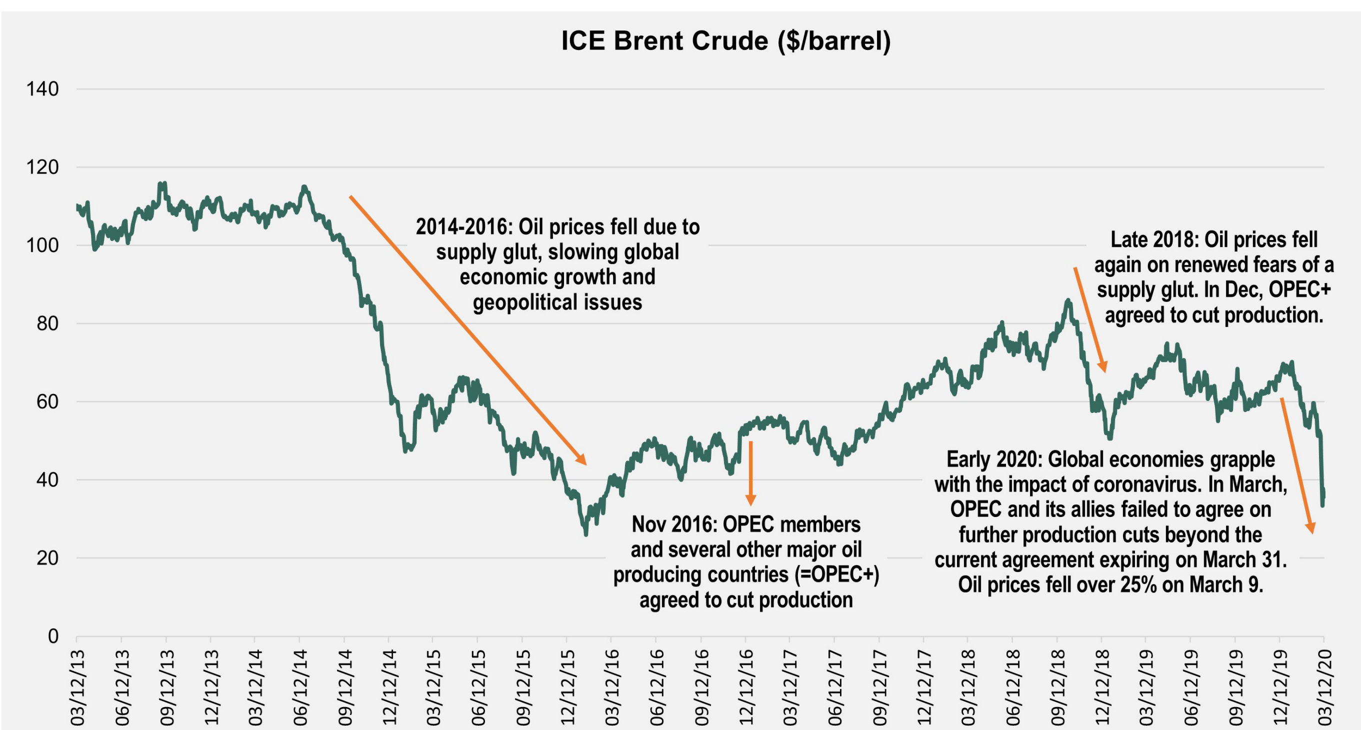
What happened to oil prices?

To understand the recent oil price crash, it may be useful to rewind the timeline to late 2016. At the time, after two years of depressed prices, OPEC nations and several non-OPEC producers (OPEC+) agreed to limit oil production as part of their efforts to end the global supply glut. Oil prices recovered subsequently.

In late 2018, oil prices dropped as supply outstripped demand and global inventories started to rise. OPEC+ agreed to cut production in December 2018[1] and oil prices stabilized.

Earlier this year, amid the COVID-19 outbreak and the resulting drop in oil demand, oil prices started to fall again. Globally, airlines cut capacity in February and March, and are expected to continue doing so in the months to come.[2] Prior to the virus outbreak, the IEA (International Energy Agency) forecasted 1.2mb/d (million barrels per day) of global oil demand growth for 2020.[3] In its March report, the agency expected global oil demand to fall in 2020—the first full-year decline in more than a decade.[4]

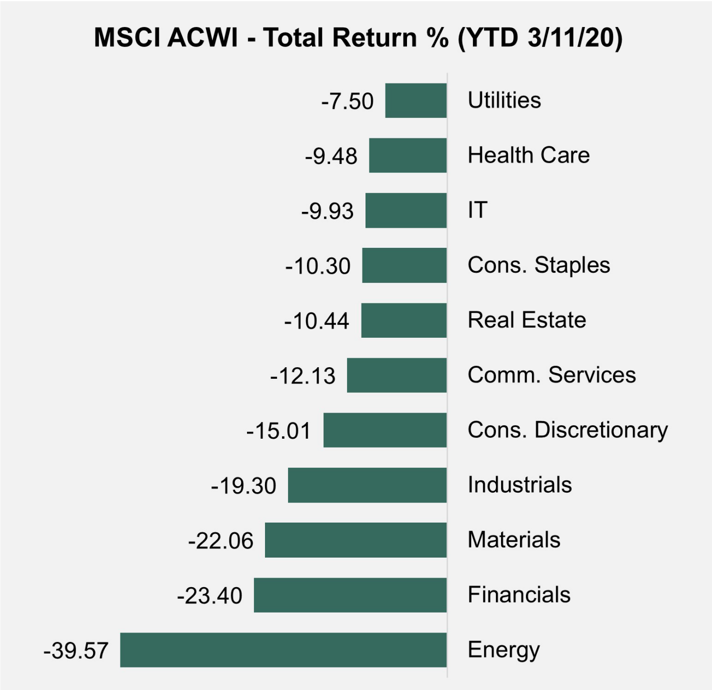
OPEC responded by announcing a plan to extend (current agreement ends at the end of 1Q20) and deepen supply cuts to avoid a sharp sell-off.[5] However, the plan fell apart after the organization failed to secure Russia's commitment. On March 6, Russia announced that it would no longer curtail production beginning in April. This led Saudi Arabia to launch a price war and announce that it would raise production and cut prices.[6] As a result, oil prices fell by over 25% on March 9 (see chart below).



Source: FactSet, Brandes as of 3/12/2020.

What has been the impact on the energy sector globally?

As expected, energy companies suffered from the oil price drop. Energy is by far the worst performing sector in global markets year to date (see chart below). In the U.S., the sector has lost nearly 70% since its bull market high in June 2014.[7]



Source: MSCI via FactSet as of 3/11/20.

How long can the low oil-price environment last?

As bottom-up investors, we make no attempt in predicting the movement of oil prices. Saudi Arabia and Russia's readiness to increase their production implies that both countries can afford to withstand the lower prices, so it's a question of how long they would be able or willing to do so. According to IMF, oil directly accounts for more than 40% of Saudi Arabia's 2018 gross domestic product (GDP), nearly 70% of fiscal revenues, and close to 80% of exports.[8] Moreover, non-oil activity is highly dependent on government outlays financed by oil revenues. Russia's economy is more diversified, but still highly dependent on oil & gas (30% of GDP and 60% of exports).[9]

Based on a report by Scotiabank, Saudi Arabia can maintain the current price levels for nearly five years before completely draining its sovereign reserves.[10] However, we believe it is unlikely that the kingdom would go that far, especially considering other OPEC members will likely pressure it to take measures to stabilize oil prices. At current price levels, we believe many oil producers globally will not be able to reach cash flow breakeven for 2020.

It should also be noted that oil prices could move up even without OPEC/Saudi Arabia and Russia cutting production. Essentially, prices are likely to recover if or when demand catches up to supply and starts working off the global inventories. In addition to a significant supply cut by OPEC (which seems unlikely to happen over the next several months), this could happen by:

- Demand recovering with the end of travel restrictions and economic disruption from coronavirus (potentially a few months away as well).

- Non-OPEC supply falling (lower prices tend to lead to lower investment, which then leads to lower production)—we think this is most likely to happen in the next year.

- A combination of these possibilities (OPEC supply cut + recovering demand + falling non-OPEC supply).

Depending on the magnitude and combination of the three factors, oil price recovery is likely between one to three years away, based on our analysis.

How has this affected the intrinsic value (IV) estimates of Brandes' oil & gas holdings?

If companies realize an oil price below our "normal" assumption, it will impact our valuation through the realization of lower cash flows, lower investment and lower future production. Adding insult to injury, the industry has historically invested pro-cyclically, with falling capex (capital expenditures) during low commodity price environments and higher capex at the peak. It should be noted, however, that cuts in capex will likely reduce supply over the long term and bring supply/demand back in balance at some point. In other words, it could eventually be a benefit for oil prices.

If for simplicity we assume the oil price is $30/bbl globally and remains there for a year, the impact to our estimated IVs would be a 10-15% decline for most of our oil & gas holdings. A few more levered companies and/or Latin American companies could see an approximate 20% decline in intrinsic value.

But valuation is not so simple. Each company's valuation is different and there are a lot of moving parts. For instance, most U.S. and European integrated oil companies would not be able to cover their dividends at an oil price of $30/bbl. While some may be able to maintain dividends, we hope that others are prudent enough to cut dividends as opposed to borrowing to maintain. Some may see potential government intervention that could provide some cushion. Lastly, these estimates assume the pain lasts for approximately one year. We expect the recovery will ultimately depend on whether emerging markets quickly return to normal and will be correlated with other industrials/materials in the portfolios. Since 2008, emerging countries have accounted for more than 100% of global oil demand growth on average, with China making up a significant portion of that growth.[11]

We have made adjustments specific to each of our holdings as well as to potential new opportunities. For existing holdings, price declines have more than outpaced reductions in our intrinsic value estimates and we are generally averaging down on large cap integrated companies in relevant strategies. In smaller cap strategies, we are seeing opportunities in exploration & production as well as oil field services companies. The new price levels may now fully reflect the risks we saw in those companies previously and those Brandes teams may start increasing exposure.

[1] Source: The Wall Street Journal "OPEC, Russia Strike Deal to Cut Oil Production," published 12/7/2018.

[2] Source: The Economist "Coronavirus Is Grounding the World's Airlines," published 3/15/2020.

[3] Source: IEA Market Report – January 2020.

[4] Source: IEA Market Report – March 2020.

[5] Source: Barron's "OPEC Prepares to Tackle the Coronavirus Fallout for Oil Prices," published 2/28/2020.

[6] Source: The New York Times "Oil Prices Dive as Saudi Arabia Takes Aim at Russian Production," published 3/8/2020.

[7] Source: S&P via FactSet; U.S. market represented by S&P 500; 6/23/2014 (bull market high) vs. 3/12/2020.

[8] Source: IMF Country Report Saudi Arabia, published September 2019.

[9] Source: Oilprice.com "Russia's Economy Is Signaling An Oil Price Rally," published 12/12/2019.

[10] Source: Scotiabank Equity Research – Energy Strategy, released 3/10/2020.

[11] Source: BP Statistical Review of World Energy 2019.

Capital expenditure (CAPEX): An expense a company makes towards the purchase of new equipment or the improvement of its long-term assets, namely property, plant, and equipment.

The MSCI ACWI with net dividends captures large and mid cap representation of developed and emerging markets.

The S&P 500 Index with gross dividends measures equity performance of 500 of the top companies in leading industries of the U.S. economy.