

Here comes 2020: The curse of liquidity might be a blessing for energy investments

APICORP's Chief Economist's Top Picks

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Before Brent prices collapsed late 2018, analysts were projecting ending the year at USD100 per barrel in the midst of a market plagued by falling crude stocks and supply risks from Iran, Nigeria, Libya and falling Venezuelan output. Fast forward to early 2020, following the “unthinkable” strike on Abqaiq and Khurais facilities on September 14 and the killing of General Soleimani, the traditional “geopolitical risk premium” in oil prices has become -- at a minimum -- inconsequential. Early February, the rapid spread of the Wuhan Coronavirus became the main bearish factor potentially slowing China's GDP growth to less than 4.8% in 1Q2020, compared to 6% in 4Q2019. The Central Bank of China announced the injection of the equivalent of \$174 billion via reverse repo operations to support the economy.

In the wake of these unthinkables, someone recently asked me if I was still confident in APICORP's [MENA Annual Energy Investment Outlook 2019](#) headline number of USD1 trillion in committed and planned investments over the next 5 years. The short answer is yes. The region's energy sector can surprise us to the upside. To me, the real cause for concern is the prevalent *attentisme* (wait-and-see attitude) in everything, from geopolitics and monetary policies to carbon pricing, all of which crystallised inside investors' mindsets.

With the wider opportunities available to asset owners expected to yield meagre returns over the new decade, this may prove to be a blessing for certain segments of the energy sector, these boast these key traits: flexibility, operational efficiency and ability to mobilise capital. More on that later.

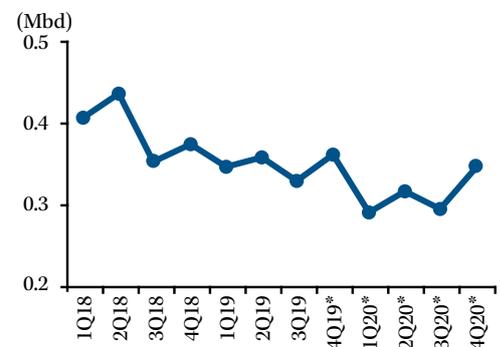
The 'wait-and-see attitude' might last for some time

The relative stability of oil prices is less a reflection of a world “awash with oil” and more of the fact that liquid oil markets are doing their job. For instance, Venezuelan and Iranian grades were gradually replaced by heavy and medium sour crudes from Saudi Arabia, UAE, Russia and others.

Furthermore, the current backwardation in oil price forward curves -- particularly Brent and DME -- indicates an incentive to sell, with seasonal demand and tightening sour crude market. Goldman Sachs even calculated that the market was “pricing an outage of 800 kbd for 3 months.” On January 31, reduced demand outlooks opened the first contango since July in the 6 month WTI contract.

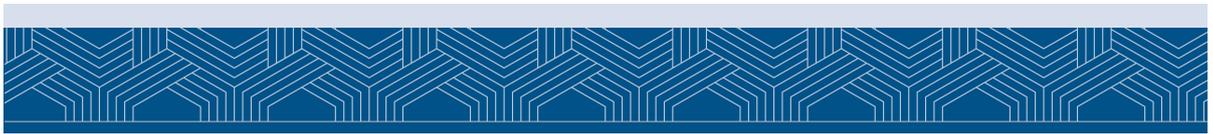
So where is the problem? **Well, market players are looking for signals on ambiguous issues, three of which might unfortunately last for some time:** macroeconomic complacency (with loose monetary policies), climate change (i.e. carbon pricing), and the tit-for-tat retaliation between the United states and Iran.

Changes in China's Apparent Oil Demand, y-o-y Change (Mbd)



Note: *4Q19-4Q20=Forecast.

Source: OPEC Secretariat - December 2019 (To be revised).



Pre-coronavirus, the global economy could have kickstarted a gradual cyclical pick-up in 2020. Even if the United States' economy is propped up by strong household consumption, the global ramifications of unstable trade policies, China's deceleration and the ballooning corporate debt-at-risk (estimated to rise to USD19 trillion in case of material economic slowdown, as per the International Monetary Fund) are yet to come.

Even though stock markets may continue to benefit from liquidity support from central banks, pro-growth policies and technical support, investors have been taking on riskier and less-liquid securities in their desperate quest for yield.

With regards to carbon pricing, the *attentisme* recently translated into calls to divest away from hydrocarbons, including gas. Even in MENA, not directly affected by these calls, our [Gas Investment Outlook 2019-2023](#) indicated a USD70 billion drop compared to our previous report. This is quite alarming, as it may potentially lead to another wave of supply crunches, sub-optimal domestic policy decisions and commercial tensions with export markets, particularly Europe.

Furthermore, as we highlighted in our November 2019 White Paper "[The Energy Transition: Reshaping Investments and Strategies](#)", what is really needed is a clear market signal for greenhouse gas emissions, as having some form of carbon pricing levels the playing field for energy technologies and provides finance stakeholders, particularly from the private sector, greater visibility.

A better year/decade for energy: private and institutional capital set for a comeback

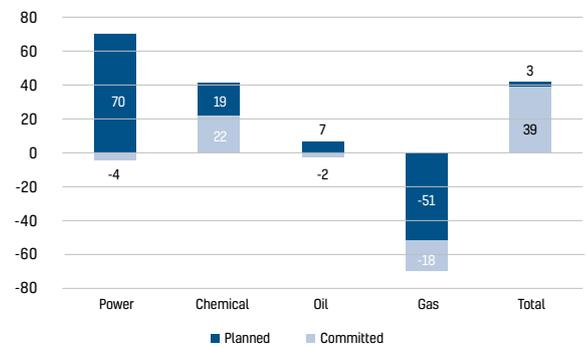
Between September 2009 and September 2019, the energy sector returns ranked dead last of all S&P 500 sectors in terms of returns, and it was not particularly close. At slightly over 30%, the sector significantly trailed the +200% returns delivered by Healthcare, Real Estate or IT.

The last few years were particularly rough, with some publicly listed companies' share prices plummeting to multi-decade lows. US shale independents learned -- sometimes the hard way -- that the flow of cheap capital from equity markets, while offering limited returns to investors, will not last forever. Those same investors are demanding resilience in a low-carbon future.

In the meantime, with USD11.6 trillion of bonds trading at negative yields, asset managers are already warning that classic investor portfolios -- say 60-40 US/European equities-bonds -- will return less than 3-4% over the next decade, which is less than half the +8% delivered over the last three decades. **As such, dividend-yielding stocks and investments, including those in resilient segments of the energy sector, should become more appealing.**

In this context, the relationship between energy companies and investors is profoundly shaping the energy company of the future. In oil and gas, flexibility, scale, and mobilisation of significant financial resources to finance working capital and manage price risk are vital for survival.

Net Change in Total Investments for 2019-23 (USD BN)



Source: APICORP

Investors willing to take on more risk in the upstream side -- including into unlisted or quasi-listed entities -- will favour putting their financial leverage and funding at the service of operationally efficient, integrated players. This trend is paving the way for a fascinating transformation of select oil and gas companies supported by institutional investors (*see inset "Select 2019 Transactions"*).

In utilities, conventional funding is more accessible to large-scale well-rated companies, prompting smaller players to tap into tailored funding mechanisms (e.g. green bonds, soft loans, crowdfunding, etc.). **In the absence of a formal carbon pricing structure, renewables have managed to benefit from such mechanisms, but the rest of the value chain -- including storage or CCUS -- lags behind.**

Select 2019 Transactions

At one extreme, on top of its USD50 billion debt, **Occidental Petroleum** received USD10 billion from **Berkshire Hathaway** for preferred stock yielding 8% in support of **Anadarko's** acquisition.

At the other, **Saudi Aramco's** USD12 billion foray into the bond market in April (more than half of the GCC debt sales in 2019), was meant to support the acquisition of a 70% stake in **SABIC**, set to close in H1 2020. The payment schedule to the **Public Investment Fund** was relaxed to end in 2025.

Stranded assets, protectionism and liquidity risks: What we will be watching in 2020?

We have been expanding the scope of APICORP's research to encompass three areas where investment support is particularly needed to facilitate sustainable (who said orderly?) energy transitions. These areas include the investment-hungry **natural gas sector**, challenge-riddled **system flexibility and storage solutions sector** and the distressed **energy service sector**. Case in point on the latter: McDermott International (NYSE:MDR), one of the world's largest service companies, lost a large part of its value and filed for bankruptcy. Its share price closed at USD 0.073 on January 31. More generally, the Dow Jones U.S. Select Oil Equipment & Services Index lost 54% since 2014. The struggle is global, prompting service companies to diversify and paving the way for consolidations and M&A activity. In 2020, we will continue tracking the deeper trends affecting these three areas, most notably **value erosion and stranded assets**, key themes of APICORP's sustainability framework.

In the power sector, declining costs of renewables accelerated asset impairment charges -- €23 billion, or 9% of the market cap of European utility companies in 2016. For fossil fuels, extreme scenarios expect one-third of planned global capex over the next five years to be stranded. Oil and gas companies are being proactive by internalising carbon pricing in their investment decisions. In 2017, several majors -- including ExxonMobil, Shell, BP and Total -- supported the Climate Leadership Council proposal for a USD40 per tonne carbon tax.

For once, oil prices could still be the least volatile market signal, barring other *unthinkables*. Coronavirus will impact demand growth in 2020, we still don't know by how much -- early estimates indicate a downward revision of 300,000 bd to 2020 global liquids demand. Assuming factors such as OPEC+ cuts, Chinese demand, trade tensions, inventories and non-OPEC supply growth continue to balance each other out, particularly post-Q2 2020, we expect Brent prices -- which averaged USD64 in 2019 -- to trade in the USD55-65 range.

In 2020, let us hope that the industry can get some clearer signals on the rest.

Let's hope for less *attentisme!*