Q&A- Oil equities disconnected from high crude oil prices due to negative sentiment, ESG-driven divestment: Josh Young, Bison Interests

Stocks of oil companies are pricing in lower realized oil prices than those currently observed in oil benchmarks, with this disconnect likely explained by ESG-driven divestment/allocation avoidance, **Josh Young, Co-Founder and Chief Investment Officer, energy-focused fund Bison Interests**, told the Reuters Global Markets Forum on Tuesday, February 15.

Shareholder pressure to return capital is helping maintain rational capital spending levels for upstream oil and gas companies, Young said, while observing that breakeven oil prices for U.S. shale companies may be higher than anticipated due to higher services costs. His favored picks include Journey Energy, Baytex Energy and Sandridge Energy.

Following are edited excerpts from the conversation:

Q: What're your current views on oil and how do you see the Russia-Ukraine situation playing out?

A: There are a lot of short-term cross currents playing out right now. There are great medium-to-long term trends of limited (oilfield) services capacity and under-investment in exploration, along with persistently stronger than consensus demand, but in the short term, there has been an oil geopolitical risk premium that has been building in the oil price and oil-related equity share prices that is coming off as it appears war and oil sanctions against Russia are less likely.

Q: In the case of war not occurring, what Brent, WTI (U.S. West Texas Intermediate) and WCS (Western Canadian Select) prices do you see?

A: I don't know, there might be another $3-$5 per barrel still built into the oil price -- I see WTI at about $91 right here. I don't think differentials should change too much on this for WCS and Brent, so similar spreads to today, but oil often moves with momentum and could easily overshoot, like we've seen in several pullbacks over the last year.

Q: What are your views on U.S. shale, are we going to see it coming back to previous levels?

A: I think U.S. shale production could eventually rise to all-time highs, but it would require significant capital investment in oil services and far higher capital expenditures than we're currently seeing and might take more than two years.

Q: Capital expenditure in the conventional oil industry has been lagging since 2015 with ESG (Environmental, Social and Governance) policies being implemented, too. Do you think this will continue to support oil prices, preventing them to fall meaningfully?

A: It seems likely that ESG-related divestment will continue to inhibit capital investment to some extent in the industry. I agree it is a factor, but as oil prices rise eventually it will be possible for U.S. shale companies to grow within cash flow. However, there is concurrent shareholder pressure to return capital via buybacks, dividends, and debt paydowns, which is helping maintain rational capital spending levels for upstream oil and gas companies.

Q: What is the current breakeven oil price for U.S. shale?

A: It is quite contentious actually. Our view is higher than consensus, because many companies have been under-investing in their working capital by completing and bringing more wells on production than they have been drilling. We just saw today that Continental Resources raised their budget 23% -- excluding an acquisition -- and are only projecting to grow 3%. So, for them, maybe their breakeven including all costs and declines is $80+?

It varies widely across the industry and specific assets, but the financial history of the E&P (exploration & production) companies illustrates that break-evens are much higher than had been historically represented. I've read around $85 for U.S. shale breakeven.

But there may be a bias higher as services costs increase, like we saw with Continental.

Q: What do you make of the big disconnect between how oil's rise and how oil-tied equities are struggling to reflect that gain?

A: There have been disconnects in oil prices versus oil equities in both directions over the past 18 months. I think broadly we're seeing oil equities lag due to negative sentiment and ESG-driven divestment/allocation avoidance.

As an investor, this is promising to me, as it offers higher free cash flow yields and higher potential long term returns to the equities.

Q: Do you think that without U.S. shale production in recent years, oil supply would not have met demand?

A: It's hard to say, there was growth elsewhere, and under-investment elsewhere because of shale, but shale certainly was the majority of world production growth over the past decade.

Q: Do you think the market is overheated for deals? Are there any areas of the oil value chain that you see consolidation due, who could be at play?

A: I don't think the market is overheated. If anything, there are many deals that should happen that haven't yet, across the whole oil and gas value chain. I think there have been fewer deals than there would have been because of the prolonged oil downturn since 2014, and with oil prices recovering, it is allowing for more deals to "catch up".

Q: What is your take on oil exploration right now?

A: I think you'll see many smaller companies continue to merge or to be acquired by larger companies, in E&P, services and midstream. Oil exploration has been under-invested in for years. It is high risk and very expensive though. I read a Reuters article about Exxon in Brazil, where they spent $4.5 billion and have no production to show for it yet. So, there should be more of it, but it is not always the best path for most oil producers.

Q: What's your firm's framework to approach energy equity investing?

A: We're value + catalyst investors. So, we're always looking for companies that are very inexpensive, have survivable balance sheets, and have a path to unlock that value. We also look for disconnects in the market understanding of asset productive potential, sale value, local realized pricing, etc. We've found that to be particularly promising post-COVID-19 with so few oil investors with experience remaining in the space.

Q: What are your favourite sector names and your relevant theses on them?

A: I'll address a few stocks that I've talked about publicly already, which I own and which I'm not recommending. First is Journey Energy, a small cap producer of oil and gas in Canada - they have a low decline rate – about 13% - which means they need to spend very little to keep their production flat.

They will likely grow this year though, as they haven't spent drilling capital in some time. And they will likely pay off most of their debt, which has fallen through repurchase and paydown from $150 million in November 2020 to less than $50 million today.

They are barely covered by any investment bank research, and they have power generation assets and midstream that are not appreciated by the market. Although to be fair, even their basic oil and gas production may be worth twice or more what they are trading for today at $90 oil, so maybe they are getting negative value for their integrated power generation business despite being in an undersupplied power market in Alberta.

A mid cap that I've talked about is Baytex Energy, which made a big discovery onshore last year, drilling what may have been the most economic well onshore North America in the new "Clearwater" play. They trade at a discount to peers, are poorly understood due to cross border assets in both the U.S. and Canada, and their new field appears to not be priced in. Lots of potential for them to outperform expectations, and if compared to U.S. producers, they look even cheaper.

And another small cap is Sandridge Energy, which is a post re-organization company that did not change its name. It has been building net cash on its balance sheet - it may be close to 50% of its market cap in cash at this point, from $50+ million of debt in November 2020. It has kept production flat while paying off debt and now building cash and may implement a dividend or get active with an announced buyback. The board at Sandridge is controlled by its largest shareholder, Carl Icahn.

These are my off the cuff comments, please don't rely on any of this in an investment decision, but I do own these stocks and they are some of my largest positions.

Q: What's your outlook on the natural gas markets? Do you like any players in that area?

A: Natural gas is complicated. It's easier to grow and demand is growing less rapidly, but it is also a lot cheaper than oil on an energy equivalent basis. Most of Sandridge's production is natural gas. I like it as a play on potentially higher natural gas prices, with downside protection from the large and growing cash balance that should shield it from natural gas price downside volatility.

Q: Do you have any parting views for us/things to look out for?

A: I think it's easy to get caught up in short term noise and volatility. We're in the early stages of a multi-year oil equities bull market, valuations are compelling, the sector is still quite hated, and it is still at less than half of where it was the last time oil prices were this high -- measured by SPDR S&P Oil & Gas Exploration & Production ETF (ticker: XOP) in 2014 vs today --. I think it's a good space to spend time on, and that there are still very interesting opportunities despite the initial bounce off of seven-year lows.