APRIL 2020

ATLANTIC CAPITAL MARKETS

Oil Wars – A New Hope

01872 229 000

www.atlanticmarkets.co.uk

The Crash

With the recent collapse in oil prices it has really impacted the sector overall and as the dust settles it offers great opportunity to take a look at the sector and the prices on offer. Make no mistake though, the drop was caused by disagreements between Russia and Saudi over supply levels. This rift may hang around for a while and in turn continue to create volatility in the oil price.

Disagreements between the two powers is nothing new but on this occasion, it has overflowed into the markets. The big question is... will they reach an accord?

This could rattle on for some time or be over swiftly due to the unpredictable nature on both sides. Therefore, it is better to use the situation to look at the big drillers who are more resilient to low oil prices.

OPEC+

In 2016 the OPEC+ alliance was initially formed by Saudi Arabia and Russia in response to the previous collapse in oil prices to $30 a barrel triggered by growth in the US shale industry. As U.S. shale oil production increased its market share, it took its toll on oil prices and they crashed from above $110 per barrel in 2014 to about $27 in 2016.

In September 2016, Saudi Arabia and Russia agreed to cooperate in managing the price of oil, creating an informal alliance of OPEC and non-OPEC producers that was dubbed “OPEC+.” By January 2020, OPEC+ had cut oil production by 2.1 million barrels per day (bpd) in a move to stabilise the market, the two leading exporters had created an uneasy alliance and maintained control of oil prices and supply.

The tensions started to mount when Saudi decided they wanted to increase the current production cut to 3.6 million barrels through 2020 to take account of weaker consumption based on the Global coronavirus epidemic, this rattled the Russian President Vladimir Putin, who was really more concerned about losing ground to American oil producers and so refused to go along with the plan. The Russian energy minister, Alexander Novak then fired the first shot in the war when he said countries could produce as much as they please from April 1. Russia had basically sent a message that they were walking away from the alliance after tiring of cutting production to stabilize prices and felt that the policy of supply restraint gave more room for US shale companies to grow. Saudi Arabia then warned Russia would live to regret the decision. And so, it began.

Oil Price Chart

The fallout from this was huge and sent prices into a tailspin...One that has only just started to show some life on hopes of an end to the Oil War. Needless to say, that such a crushing drop in the underlying commodity has had a serious impact on stocks operating in the Sector and countries reliant on exporting. The Oil majors will be able to ride out such drops, but the fallout has been far more devastating for the lower tiered drillers and explorers. There is very simple maths behind this. All Oil companies and oil producing nations have a certain price they can get the black stuff out of the ground for, the difference between this number and the oil price is their margin. The higher the cost to extract the lower the profit margin and the more vulnerable the company or country is to the price of Oil.

The data below also highlights the cost for each country to produce Oil, you can clearly see that Saudi has the lowest total cost and is therefor better positioned than Russia or the US to ride out low prices.

Country	Production Cost(Per Barrel)$	Total Cost(Per Barrel)$
United Kingdom	17.36	44.33
Brazil	9.45	34.99
Nigeria	8.81	28.99
Venezuela	7.94	27.62
Canada	11.56	26.64
US (Shale)	5.85	23.35
Norway	4.24	21.31
US(Non Shale)	5.15	20.99
Indonesia	6.87	19.71
Russia	2.98	19.21
Iraq	2.16	10.57
Iran	1.94	9.09
Saudi Arabia	3	8.98

The Opportunity

Whilst Oil prices are still depressed this raises great opportunities to buy into Oil stocks at seriously lower levels. Myself I would personally stick to the majors Such as BP and Shell rather than chasing some of the more exposed oil explorers, yes in percentage terms the pullback has been bigger on the lower tiered oil plays but that in itself simply highlights how fragile they are to oil prices. The bounce backs will undoubtably be bigger in percentage terms, if they make it through that is.

For me the steadier and safer way to attack this move is by looking at the bigger players,

And, let's be frank the war between Russia and Saudi could continue to rattle on and in that time prices will undoubtably still fluctuate. A meeting which was supposed to take place on April 6th had been cancelled due to tensions between Saudi and Russia and in the near-term volatility could remain high.

Royal Dutch Shell

Ticker: RDSa/RDSb.

Objective: STRONG BUY

A Brief History

Royal Dutch Shell PLC or as its more commonly known "Shell", is an Anglo-Dutch oil and gas company headquartered in the Netherlands and incorporated in the UK. They are also one of the worlds supermajors and the third-largest company in the world measured by 2018 revenues and the largest based in Europe.

- 1907 - Shell was formed through the amalgamation of the Royal Dutch Petroleum Company of the Netherlands and the "Shell" Transport and Trading Company of the United Kingdom.

- 2005 – The firm unified and operated as a dual-listed company, whereby the British and Dutch companies maintained their legal existence but operated as a single-unit partnership for business purposes.

- 2016 - Shell acquired BG Group making it the world's largest producer of liquefied natural gas.

Positioning

Shell is vertically integrated and is active in every area of the oil and gas industry, including exploration and production, refining, transport, distribution and marketing, petrochemicals, power generation and trading. It also has renewable energy activities, including biofuels, wind, energy-kite systems and hydrogen. Shell has operations in over 70 countries, produces around 3.7 Mn barrels of oil equivalent per day and has 44,000 service stations worldwide. Shell Oil Company, its principal subsidiary in the United States, is one of its largest businesses. Shell holds 50% of Raízen, a joint venture with Cosan, which is the third-largest Brazil-based energy company by revenues and a major producer of ethanol. Shell has a primary listing on the London Stock Exchange and is a constituent of the FTSE 100 Index. It had a market capitalisation of £216bn. They are the largest of any company listed on the London Stock Exchange. It has secondary listings on Euronext Amsterdam and the New York Stock Exchange.

Business Scale

Shell has consistently earned higher revenues than BP due to the larger scale of its operations. Over the last ten years, Shell's revenues were an average of 22.2% higher compared to BP.

Recent Trading and News

As a response to the coronavirus outbreak and the recent oil price collapse Shell have announced several measures, all designed to protect in the short term to help maintain the long term.

The first bold move is to reduce spending plans by £7.2bn and aim to reduce operating costs by between $3bn and $4bn this year while cutting its planned capital expenditure by somewhere between $5bn - $20bn for the year. They have also suspended plans to buy back the shares which were paid in lieu of a dividend during the last oil market downturn in 2016. This has all been done with a view of trying to protect the cash flows and maintain one of the biggest annual shareholder pay-outs of any company.

The firm has also recently secured a new $12bn credit facility to further safeguard its dividends and investors. RDSB stated this had boosted its available liquidity to more than $40bn.

"We have seen and expect significant uncertainty . . . with regards to prices and demand for oil, gas and related products," Shell said, citing the impact of coronavirus on the global economy as well as the Saudi-led price war and a flood of new supplies to the market.

Shell said the effects of the coronavirus crisis would primarily be reflected in this month's earnings, with only a "relatively minor impact" in January and February, before most of the restrictions on movement and activity were imposed in countries worldwide.

"Shell has the balance sheet capacity and ability to cut capex to survive in the current environment without a significant cut to dividends, but if this outlook was to last for more than nine to 12 months, we would expect a cut," said Biraj Borkhataria at RBC Capital Markets.

BP Plc

Ticker: BP.

Objective: Capital growth and income

A Brief History

BP is a British multinational oil and gas company headquartered in London. It is one of the world's oil and gas supermajors.

- 1908. The founding of the Anglo-Persian Oil Company, established as a subsidiary of Burmah Oil Company to take advantage of oil discoveries in Iran.
- 1935. It became the Anglo-Iranian Oil Company
- 1954. Adopted the name British Petroleum.
- 1959. The company expanded beyond the Middle East to Alaska and it was one of the first companies to strike oil in the North Sea.
- 1978. British Petroleum acquired majority control of Standard Oil of Ohio. Formerly majority state-owned.
- 1979–1987. The British government privatised the company in stages between.
- 1998. British Petroleum merged with Amoco, becoming BP Amoco plc,
- 2000-2001. Acquired ARCO and Burmah Castrol, becoming BP plc.
- 2003–2013. BP was a partner in the TNK-BP joint venture in Russia.

Positioning

Bp is a "vertically integrated" company, meaning it's involved in the whole supply chain – from discovering oil, producing it, refining it, shipping it, trading it and selling it at the petrol pump. BP has operations in nearly 80 countries worldwide, produced around 3.7 million barrels per day (590,000 m3/d) of oil equivalent, and had total proven reserves of 19.945 billion barrels (3.1710×109 m3) of oil equivalent. The company has around 18,700 service stations worldwide. Its largest division is BP America. In Russia, BP also own a 19.75% stake in Rosneft, the world's largest publicly traded oil and gas company by hydrocarbon reserves and production. BP has a primary listing on the London Stock Exchange and is a constituent of the FTSE 100 Index. It has secondary listings on the Frankfurt Stock Exchange and the New York Stock Exchange.

Recent Trading and News

BP have already prepared investors for a blow and announced an expected $1bn (£800m) financial hit in its first-quarter results, this has also led to plans to cut spending by around 20% in response to the current pressures in the market. The annual spending budget has been cut by almost a quarter, to $12bn, to protect the financial health of the company during the coronavirus crisis. This will include a $1bn cut in spending on its US shale projects.

"This may be the most brutal environment for oil and gas businesses in decades," the BP boss Bernard Looney said. "But I am confident that we will come through it – we know what to do and we have done so before."

BP assured investors that it remains committed to growing its cashflows and shareholder pay-outs over the long term by "acting quickly and decisively" to protect its finances in the face of the crisis.

Their crisis plans include steps to cut operating costs by $2.5bn by the end of 2021 and complete a programme to sell off $15bn of assets by the middle of next year. BP's decision to scrap $1bn of spending from its US shale business, BPX, comes as a blow to the company after it paid $10.5bn to become one of the biggest US shale producers a little over a year ago in a landmark deal with BHP. It expects BPX to produce about 70,000 barrels of oil a day in 2020, about 14% lower than its production last year.

Oil Exploration Stocks – High Risk / High Reward

For those with a much higher risk appetite, less of a view for dividends, longer term investment horizon and the desire to look at the lower tiered Oil plays then there is also room for potential growth and opportunity but as a word of caution I would always suggest approaching with a smaller position size and wider spread of different companies in order to try and smooth out returns. Look to create a mini portfolio within your portfolio if you will. Some of the key players in this area have seen share prices hit massively and if they can make it through the crisis offer the potential for huge gains. The big word in all of this of course is...**IF**

Jersey Oil and Gas

A Brief History

The company was founded in March 2014 and immediately identified opportunities in the UK North Sea. At the time the area was going through a sustained crisis following years of under investment, declining production and unsustainable costs, against a backdrop of falling oil prices.

At the time this move was seen to be a big chance and highly risky, but JOG was one of the few companies to see this as an opportunity and in August 2015 became a public company. They floated

on the AIM market through the acquisition of Trap Oil Ltd. The combined entity was then recapitalised, the balance sheet was cleaned up and following a share consolidation the company was relaunched as Jersey Oil and Gas plc.

JOG then launched a farm out process in February 2016 which concluded with a deal with oil major Statoil (whose name subsequently changed to Equinor), This resulted in the first promoted farm out deal to be done in the UK North Sea in over three years, which led to a drilling commitment by Statoil. 2017 was a landmark year for JOG, as they were an instrumental catalyst for the drilling of three exploration wells in the UKCS one of which resulted in the highly publicised Verbier oil discovery.

On the back of this success, JOG completed a significant equity financing of £24m, strengthening the shareholder base and ensuring they maintained their position at the table through the appraisal stage of Verbier.

Oil and Gas exploration is an area of explosive moves, both good and bad and as a relatively small unknown operator recent news flows have certainly brought JOG to the front of investors focus. The company has reported they have been awarded three new blocks in the Greater Buchan Area in the Moray Firth, adding 100million discovered barrels of oil equivalent to its portfolio. It also added prospective resources of 300million barrels of oil equivalent. But who are they and what do they do and is this really the start of something big or just a flash in the pan?

Tullow Oil

A Brief History

The Company was founded by Aidan Heavey in 1985 in Ireland as a gas exploration business, with its headquarters now in London. It started in a small town called Tullow, just south of Dublin, Ireland. In the 1980s there was a considerable rush of companies starting off in the North Sea and Irish Celtic Sea. At a time when this was the main focus Mr Heavy had the foresight to look at the smaller and unloved fields in Africa, which had been left behind by the majors and had no-one to work them. Tullow has a primary listing on the London Stock Exchange and is a constituent of the FTSE 250 Index with secondary listings on the Irish Stock Exchange.

Operations

The Group has interests in 80 exploration and production licences across 15 countries which are managed as three Business Teams: West Africa, East Africa and New Ventures.

Recent Woes

Tullow Oils problems started long before the recent drop in oil prices and investors really need to be aware of this, they had scraped dividends and seen prices collapse after the last oil find.

Heavy Sour Oil

The problems really started to show themselves at the beginning of November when they downgraded the full year production guidance off the back of a halt in drilling at one of the Ghana sites. This led to an initial drop of around 30% on the share price.

‘In West Africa, our non-operated assets continue to perform well,’ Tullow Oil CEO Paul McDade said. ‘However, Ghana production has not met our expectations this year and we are working closely with our Joint Venture Partners to ensure that both fields perform to their potential.’

As if this wasn’t bad enough the downgrade to full year guidance was then followed up with the announcement that recent discoveries in Guyana contained low quality, heavy, sour oil which have significantly less commercial value and a much higher cost to process.

(Sour crude oil is crude oil containing a high amount of the impurity sulphur. It is common to find crude oil containing some impurities. When the total sulphur level in the oil is more than 0.5% the oil is called “sour”.

Sour crude dramatically increasing the cost of processing.)

Hurricane Energy

The company was founded back in 2005 by Dr Robert Trice with a belief that ‘fractured basement reservoirs’ could be a significant untapped resource.

Basement rock sits beneath the traditional oil producing source rock. Most oil fields worldwide have tended to terminate drilling once the source rock has been penetrated. However, this has left behind a potentially large untapped resource sitting in the basement layer below.

The basement layer can naturally contain huge structures of fractured rock that are able to trap significant volumes of oil.

It is estimated that fractured basement reservoirs contain around 20% of the world’s remaining oil and gas resources.

Many countries have already successfully exploited basement reservoirs including the USA, Brazil, Venezuela, Morocco, Libya, Algeria, Egypt and Vietnam. However, the UK has been late to the party.

Until Hurricane came along there had been no targeted efforts oil in basement reservoirs despite the fact that several discoveries had been previously made by accident.

Small team, Big dream

Hurricane currently employs only a small team of experienced specialists and utilises contractors to carry out a lot of the engineering and development work.

Hurricane is led by its founder and CEO, Dr Robert Trice, who gained most of his geological experience at Enterprise Oil and Shell and is a leading expert in fractured basement geology. Reassuringly, he comes across as an engineer rather than a polished salesman - there’s been far too many of those over the years, particularly on AIM listed resource stocks. In fact, Dr Trice still get his hands dirty, basing himself out at the rig a lot of the time, rather than sat behind a mahogany desk. The Board also includes some big hitting non-execs including the former Chief Geologist of BP and ex Finance Director of Premier Oil.

Exploration niche

Hurricane’s management recognised the potential of this new ‘exploration niche’ and so set about acquiring a series of basement prospective licences in the UK Continental Shelf (UKCS).

Initial efforts concentrated on acreage in the West of Shetlands, where historical studies indicated the presence of oil in the basement layer.

In 2006 the Company's first drilling effort, the Wellington sandstone prospect, came up dry. Undeterred, the Company continued to add to its licence portfolio.

2009 marked a key turning point for the Company after it discovered oil at its flagship Lancaster well. This paved the way to raise more money to pay for further drilling.

While much of the focus has been on its first discovery, Lancaster, Hurricane has made two other potentially massive discoveries.

Its second basement discovery was Whirlwind, a large structure approximately 2km deeper than Lancaster and is thought to contain in excess of 200 million barrels.

Hurricane's third basement discovery is Lincoln. Initial analysis has indicated that the well could hold 250 million barrels.

Summary

Oil and Gas stocks are the bedrock of the markets and as far as the income investor is concerned should also be the cornerstone of all strong long-term portfolios. The big players are currently doing all they can to protect and maintain dividends which makes the current depressed prices even more appealing. Make no mistake the drama in the Oil price war could rattle on for quite some time and price fluctuations could still be wild but in the long term the big players will come through. The exploration side of the sector is a different story, no income just the potential for large moves on discoveries(both good and bad) It takes a certain investor to look at this area in the current crisis and so could be highly lucrative for the long term recoveries. Buy with caution, spread the risk and do not be afraid to pluck out the weeds.