ALLIANCEBERNSTEIN

21 April 2020

PERSPECTIVES ON THE OIL MARKET

CONCENTRATED AUSTRALIAN EQUITIES

We have had a bearish view on oil for more than a month and believed that it would drop below $10/bbl. The demand destruction from COVID-19 is significantly greater (about 30 million barrels per day) than the OPEC+ attempt at curtailing production (about 10 million barrels per day). As a result, storage is filling quickly and particularly in the US hence the weakness of WTI versus Brent. With US Cushing storage filling rapidly traders wanted to avoid taking physical delivery this has driven May WTI futures into negative territory (US$-37.63 per barrel). Although we have seen the capitulation in oil prices, we don't believe we have yet seen a capitulation in oil stocks and therefore this is not yet an opportunity.

For Concentrated Australian Equities (CAE) we are underweight oil producers and indirect exposures to this oil price weakness.

- **Oil and gas producers** – most Australian listed equities will be unprofitable at current prices and for some balance sheets will continue to be stretched as cash flows go negative for most of them. For CAE we are underweight Oil and BHP. We have a ~2.8% exposure to Beach because its domestic gas business remains profitable and it has less exposure to global oil prices. We believe this is the best value opportunity in the oil and gas space.
- **Airlines** – typically airlines benefit from falling oil prices. However, when airlines hedge the oil price but then stop flying they have to pay to cover their out of the money hedges. This is a negative for Qantas (and Virgin). We don't own any airline stocks.
- **Energy traders** – Macquarie makes about 25% of its pre-provision profit from trading. It typically benefits from trading profits when markets are volatile. However, in extreme moves they could be an increased chance of windfall gains or losses. In particular if counter parties default a net neutral hedge position could result in a loss. We don't own Macquarie Bank.
- **Bank debt** – the major banks do not disclose their lending to oil producers, but it is probably only a few % of assets. However, they are predominantly focused on Australian based producers which are mostly listed such as Woodside and Santos (which either have strong balance sheets and/or the ability to raise equity) or the global majors such as Shell. ANZ may have more exposure in Asia but we don't own ANZ shares. There may be more risk in indirect exposures to energy e.g., Virgin moving into administration. Banks are generally cautious on disclosing exposure to individual names. CAE is underweight banks in part due to our negative outlook for bad debts.
- **Refiners** – Refiners are hurting as volumes are down (about 50% in Australia and 85% in New Zealand). The refining margin is hard to estimate as actual market prices for crude products may be quite different from listed prices. However, refining margins are unlikely to offset the volume declines and therefore this is a negative for refiners. We don't own Caltex but do have an exposure to Z Energy which will benefit from New Zealand moving from zone 4 to zone 3 restrictions for COVID-19. It also benefits as it is predominantly a retailer and retailer margins according to NZ government data are rising. It can also generate cashflow from falling working capital and potentially selling carbon credits it has pre-purchased.

Finally, in most commodity markets the bigger the boom the bigger the bust. The reverse is currently true for oil. The bigger the bust the bigger the boom. To balance the market before storage fills, we are likely to see big reductions in current production and the capex required to support future production. As a result, in the medium term we could see a significant spike upwards in oil prices. However, as noted above we need to see the equities capitulate before this becomes an opportunity.