Energy Sector Review

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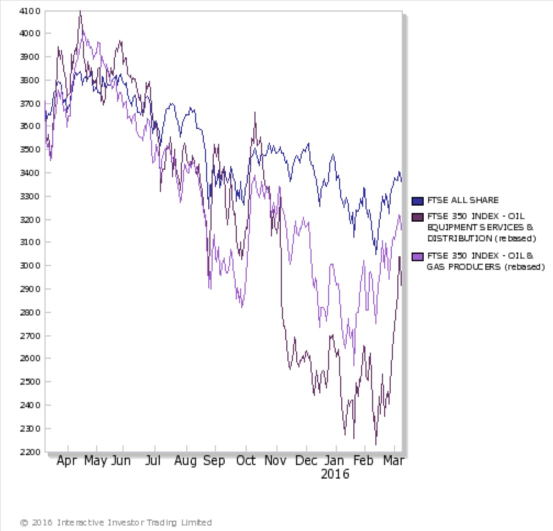

FTSE 350 Oil Eqpt & Services	CY2016	CY2017
PE	11.6	10.9
P/Book	1.5	1.4
EV/Sales	0.6	0.6
EV/EBITDA	7.3	7.0

FTSE 350 Oil & Gas Producers	CY2016	CY2017
PE	22.3	12.0
P/Book	0.9	0.9
EV/Sales	0.8	0.6
EV/EBITDA	5.5	4.2

FTSE All Share	CY2016	CY2017
PE	16.3	13.9
P/Book	1.7	1.7
EV/Sales	1.5	1.3
EV/EBITDA	9.0	8.0

Source: Bloomberg

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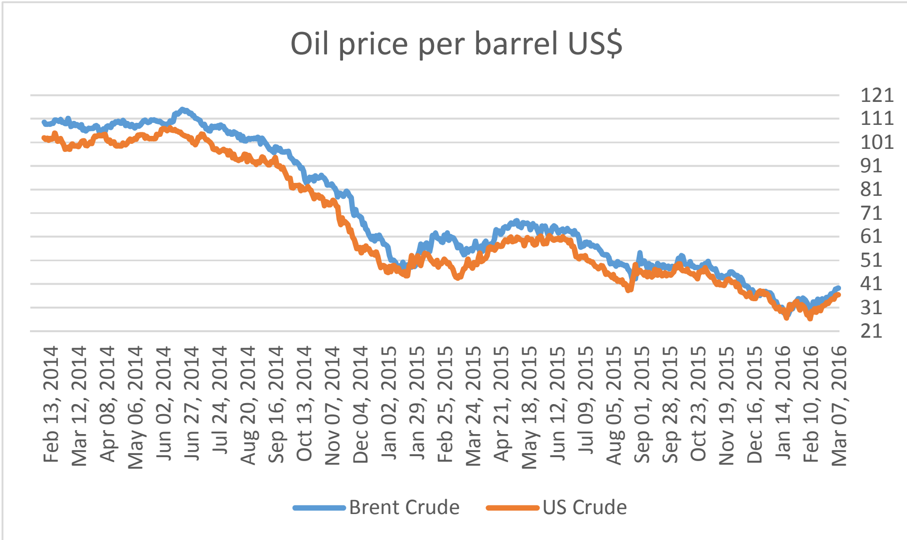
The end of the world as we know it?

According to the LSE stats there was no Oil & Gas fundraising activity on the main market during 2015 and just £1.2m raised on AIM. The chart below clearly demonstrates the pain that oil producers are feeling with global prices having been in almost constant decline since mid-2014. Both Brent and West Texas Intermediate are now hovering between $30 and $40 per barrel having rebounded from their lows over recent weeks.

Source: Investing.com



This low pricing environment challenges the margins of even the most efficient of hydrocarbon producing operations, and we have seen a swathe of job cuts across the sector. According to Graves & Co this number had reached a quarter of a million in the ten months to November 2015, and the trend is continuing with **Royal Dutch Shell (LON:RDSB)** recently completing its $70bn merger with BG Group. However that deal was first announced with oil prices in the sixties. Indeed there has been some shareholder dissent over the deal with Standard Life speaking out publicly over value destruction at these commodity prices. Looking ahead the large drop in sector earnings ratings from CY2016 to CY2017 suggests analysts are confident that the majors are taking appropriately drastic actions to rebuild profits. Certain explorers such as **Pantheon Resources (PANR)** are taking advantage of the low cost environment and accelerating their plans. The company recently raised $30m in a placing after originally seeking to raise $25m. The company has drilled two successful onshore wells in Texas and the shares are up 65% over the last month.

However the supply and demand of Hydrocarbons is a complex web of moving parts. Investors find themselves asking is this pricing regime here to stay? Where are the opportunities? Are both Oil and Gas going in the same direction? What about renewables? Are there regional pockets which defy global trends?

Oil supply has tended to defy market forces as prices continue to decline. Some see this as political posturing. In January OPEC crude oil output rose by 280,000 barrels a day in January to 32.63 million barrels a day as output from Iran. Freed from international sanctions that restricted its oil production, Iran came back online and Saudi Arabia and Iraq "all turned up the taps," according to the (IEA) International Energy Agency.

A major shift in the energy market has been the resurgence of the USA towards the top of the global hydrocarbon production league tables as a result of the shale revolution. However with higher than conventional production costs this may well reverse somewhat in the short term at least. To complicate the picture further Russia has brokered a deal with several of the major oil producing countries including Saudi Arabia agreeing to freeze production levels but the practicality of implementing such a deal remains to be seen.

On the demand side a deteriorating global macro-economic outlook, particularly in Europe and China is likely to drag on sentiment for some time to come. On a longer term view, shifts in the way our transportation is powered could have a more dramatic effect. I still do not know anybody who owns an electric car but I know that every time I take a taxi it tends to be an ugly Japanese hybrid, and with battery costs plummeting, and manufacturers upping the pace of development, it is possible that we start to see a meaningful shift in driver behaviour. Certainly the rhetoric and indeed signed international agreement that emerged from the COP21 agreement in Paris last year suggested that emissions reductions are likely to become a greater part of government policies.

One company set to accelerate its growth on the tailwinds of the renewables boom is the energy storage and clean fuel company **ITM Power (LON:ITM)** having recently announced a pipeline of £18.7m for its integrated hydrogen energy solutions.

Of course there are many beneficiaries of lower energy prices. Airlines in particular should enjoy a big reduction in variable costs if they have not been caught out by hedging policies which may in turn benefit demand for ancillary services such as aircraft leasing as carried out by Singapore based **Avation (LON:AVAP).**

Gas supply and demand is a complicated picture. The current price levels and mandate by the Dutch Government to limit production at the Groningen gas field (Europe's largest) is likely to sharply impact European gas production. Elsewhere in the world however Russia is still producing below capacity and with capital investment having been made when global gas market were more buoyant, it is likely that we will see global gas supply expand significantly in the coming years. According to the Oxford Institute for Energy Studies based on mandated projects (ex USA) global supply could double on an unrisked basis to circa 950 Billion Cubic Metres per Annum (BCMA). In terms of exports the US alone could move from a standing start to 120 BCMA by 2020 based on current secured offtake agreements from export projects. The first American export shipload of liquefied natural gas left the Sabine Pass terminal in Louisiana last month. Natural Gas prices were near 17 year lows this month with Henry Hub futures at $1.67 per MMBtu (British thermal units in millions) on March 4.

One stock where we see no downside from the low gas price is **Fulcrum Utility Services (LON:FCRM)** whose core business is gas connections to residential and industrial premises. The company has a solid revenue base and is on track to establish itself as the go to partner not just for gas connections but for multi-utilities having recently added electricity connections to its service offering. Fulcrum stands to benefit from the ongoing UK construction boom.

In terms of medium term gas demand one driver is likely to be emerging markets and with Chinese exports falling 25.4% year on year in dollar terms in February (imports down 13.8%) the immediate outlook appears weak. However with gas seen as a relatively clean burning fuel and parts of the developing world, especially Africa, pushing to increase electricity generation to an under electrified and growing population, there are more moving parts at play. China in particular is facing political pressure to replace coal fired owner stations. According to the IEA renewables may have a 26% share of global power generation by 2020. However we believe there remains scope for significant growth in gas fired power stations which at the very least can be seen as a transition fuel to the next energy age. Meanwhile gas is being applied to a growing number of transport modes, including trains, lorries and buses. Cruise ship operator **Carnival (LON:CCL)** has ordered four record breaking vessels (each with passenger capacities of over 6,000) all to be powered by LNG. At an earlier stage is research to commercialise LNG powered commercial airliners.

Green Dragon Gas (LON:GDG) operates in China and is the leading independent coalbed methane producer in the country. Gas? China? Hardly the flavour of the month! But economic growth aside China is seeking to increase Natural Gas to over 10% of the energy mix by 2020 against a current level of 4 to 5%. Green Dragon's production capacity is up 33% in 2016 to 16 BCF (Billion Cubic Feet) and based on a recent speech by the Chairman Randeep Grewal, Chinese sale prices remain stable, with Beijing keen to incentivise suppliers and the proliferation of infrastructure.

Seplat Petroleum (LON:SEPL) is an indigenous Nigerian Oil & Gas producer focussed on the lower cost onshore and shallow offshore basins with 2p working interest reserves of 281 MMboe. The newly opened Oben gas plant puts Seplat in an excellent position to supply the local market where we understand gas prices are delinked from the oil price. Nigeria's energy consumption per capita is pitiful. Gross power generation is planned to increase tenfold by 2020 with 80% of the increase expected to come from gas fired plants.

Cluff Natural Resources (LON:CLRN) showed great flexibility in 2015 due to the Scottish Government's turnaround on their stance towards Underground Coal Gasification (UCG). UCG was the group's primary focus but due to the government's decision, Cluff shifted its focus to a strong portfolio of five conventional oil and gas licenses in the Southern North Sea. Outside of Scotland, the company still has six UCG licences in England and Wales which are not impacted by the Scottish Government's decision. Cluff has shown great progress across their North Sea assets mostly notably shown through entering into a MoU with Halliburton, one of the world's largest providers of products and services to the energy industry, to collaborate and accelerate the development of the company's assets.

Ascent Resources (LON:AST) has a 75% stake in a Slovenian gas field and its share of the NPV is estimated around €200m. The gas price in Central Europe has struggled and is currently around 14c per m^3, vs around 22c a year ago. But this is not nearly as hard hit as the oil price and they can still produce and pump the gas profitably once the final permissions to build their plant are granted – which could be as soon as this month (March 2016). There is a Plan B to process the gas elsewhere in the event the permits are not granted or further delayed. The enthusiasm for Central European economies to have gas provided by someone other than Russia is understandably high, so there should not be a problem to sell everything they can produce. The biggest immediate hazard to Ascent is its balance sheet. There is a significant debt, current liabilities were in excess of £13m (June 2015) compared with current market cap around £1.7m.

Reviewed by Derren Nathan, William Lynne, and Niall Pearson

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