

Sector focus – oil

Published in Investment Week, 8 September 2010

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There is little doubt that we are in a commodities super-cycle, which started at the turn of the century. Robust growth from the BRIC economies underpins demand for energy and raw materials. The big question is how long this super-cycle might last, and whether the recent financial crisis and resultant world economic problems will endanger its longevity.

The best indicator of a super-cycle is high and rising intensity of the use of metals and oil. China's intensity is now three times that of the USA, and its rapid industrialisation and domestic needs rule its demand for energy and materials. There have been two super-cycles in recent economic history, the first in the late 1800s to early 1900s stimulated by the industrialisation of the USA. The second, from 1945-1975, was created by the post-war reconstruction in Europe and the Japanese economic expansion.

In both of these super-cycles, supply readily increased to meet higher demand. In the present environment, years of low oil prices have resulted in under-investment in exploration and lack of interest in the sector. High levels of demand have, therefore, been unable to stimulate quick growth in production. It took a major financial crisis, with the resultant drop in output and demand for energy, for production to catch up. Oil prices seem to have stabilised, for the time being, in a trading range between \$65 and \$85 per barrel.

We do not think prices will stay in this range for longer than another year. The potentially large deposits of heavy oil in the tar-sands of Canada, as well as the huge recent finds off-shore of Brazil, seem to have a marginal production cost of over \$80 per barrel, notwithstanding the significant environmental risks they pose. Other major fields around the world seem to be in decline and other new finds are too small to make a significant impact. The oil price, therefore, will continue its long-term rising trend and could reach the old highs of \$150/barrel over the next 2-4 years.

There are short term risks associated with investing in oil companies, which are closely associated with the volatility in oil prices and the potentially weak equity markets.

Smaller oil companies tend to be influenced by short-term sentiment and are thus more volatile. However, these are the companies we believe offer clear opportunities for investors. Smaller capitalisation companies controlling large reserves, which also have continuing exploration and development activities under competent management teams will benefit from growing cash-flow and a larger reserve base in a rising oil price environment. They are also prime take-over targets for larger industry players looking to improve their reserve bases. The recent takeover approach for Dana Petroleum is one of the best examples of this.

Bull points:

1. Super-cycle in oil prices is likely to continue
2. Smaller, production focused companies can outperform

Bear points:

1. Global economic problems can impact oil prices
2. Smaller oil companies can be volatile

Risk warnings

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