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The Oil Patch

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Oil at three year high

The new year has started with a bang in the oil patch thanks to oil prices surging to their highest levels in three years.

The strong price recovery is stoking merger and acquisition activity, as well as investor interest in the sector.

There should be no surprise in all that given oil prices are now massively ahead of their lows in June last year.

WTI is now trading at $US64.30/bbl, up from $US57.55 a month ago, and some 49% up on its June low of $43.01. Brent, at $US69.87/bbl, is up from $US63.96 a month ago, and is now 55% higher than its June low.

The best prices in three years are a result of OPEC's renewed commitment at its last meeting to maintain production cuts, increased geopolitical uncertainty in the Middle East and Libya, and continuing strong global demand growth (1.8mmbpd in 2017) in response to synchronised global economic growth.

But will higher prices last?

As might be expected given the strength of the rebound in oil prices since June, the big question now is will it last?

The key near-term threats to oil prices holding on recent gains are quota busting by the more hard-pressed members of OPEC because of the higher prices, record shale oil production in the United States in response to higher prices, and whether supply additions fuelled by higher prices can be absorbed by economic growth in the key economies.

Opinion varies widely on oil's next move, but there is broad agreement that the commodity has indeed found a new and higher level after the trauma of watching prices collapse from $US100/bbl in 2014.

Brent is expected to average $US60/bbl in 2018 (it averaged $US53.33 in 2017), while WTI is seen at about $US55/bbl ($US50.25 in 2017), according to the median estimate of 27 analysts surveyed by Bloomberg.

So while prices are expected to retreat from current levels, the trend of annual average prices recovering from the 2014 thrashing – Brent prices fell from an average of $US99/bbl in 2014 to $US52.35/bbl in 2015 - is expected to extend in to a third year.

Rising equity values, increased M & A activity, and paying up for risked upside

Oil's strong rebound from last year's June lows prompted substantial earnings upgrades and equity values for the oil producers as 2017 came to close.

The improved sentiment has encouraged the consortium that owns the unlisted Quadrant Energy to work towards an initial public offering in the $4 billion WA oil and gas producer later in this year, according to the Australian Financial Review.

And late in December, ASX-listed AWE was the subject of a shoot-out between Mineral Resources and Chinese interests.

Mineral Resources, a mineral processing company and iron ore/lithium producer, won the endorsement of AWE with a $526 million bid which was at a 52% premium to AWE's pre-bid price.

The scale of premium to be paid got investors wondering if the equity value of oil and gas assets in general were too low given the rebound in energy markets.

The result has been a substantial re-rating of equity values, with the surge in LNG prices also coming to the party for leading issues like Woodside, Santos and Origin.

LNG is benefitting from its link to oil prices as well as increased demand from China as part of its environmental crackdown on low quality thermal coals.

Deutsche Bank's equity desk reflected the new optimism in the oil sector, saying on January 10 that it entered 2018 feeling "considerable enthusiasm for the oil sector, both absolute and relative.''

"No doubt our confidence is helped by the much better feel to commodity markets and a price deck that, in our opinion, affords risk to the upside. Most significantly, however, our positive tone reflects our view that after three very challenging years the major oil and gas companies have repositioned their businesses to work in a $US50/bbl world and that as the benefit of the cash flows from projects start to accelerate, free cash is set for material expansion,'' Deutsche said.

Macquarie is also bullish on the outlook for the ASX oil and gas sector.

"We see the sector rallying hard off strong oil and LNG prices, and believe investors are now willing to pay for what they have avoided since oil prices crashed in 2014 – risk,'' Macquarie said.

"With oil rising we see the cycle starting to turn, and companies looking to activate growth options. Investors are already paying more than 20x earnings, which we believe is implicit in valuing growth options. As such, we are now valuing companies to include 'risked upside' as opposed to 'core' earnings.''

That last point is good news for the oil and gas explorers, particularly those with proved but as yet undeveloped resources.

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