

The Energy sector after the Gulf of Mexico crisis: Risks and investment opportunities

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Abstract: the BP oil spill in the Gulf of Mexico has caused the offshore sector significant distress. Nevertheless, one should not throw out the baby out with the bath-water and steer clear of the entire sector, which is now attractively valued. This short paper sets out our vision on the event, lays out some investment implications and presents a fund that is well positioned towards the long-term challenge of energy.

1 Unprecedented ecological disaster

The oil spill in the Gulf of Mexico created by the explosion of the Deepwater Horizon platform contracted by British Petroleum (BP) will probably produce the larger ecological disaster in the region, but will certainly make people re-think the way they see the Energy industrial sector.

First of all, US energy service companies will be much more impacted than European counterparts. Rig owners, subsea contractors, supply ships and service companies in the Gulf of Mexico are mostly US companies. The drilling moratorium for new projects (not existing production) imposed by President Obama will hit those companies. European companies have very low exposure, the largest exposure being the seismic operators but they are only of marginal importance in our funds and we do not have any exposure to US oil service companies. Our allocation in the energy sector has been strongly underweight in BP versus its peers and this underweight was increased further once the seriousness of the spill became clearer.

The declining activity in the Gulf of Mexico will force service companies to move their assets out of the region to other offshore locations (Brazil, North Sea, West Africa, Asia). This will have an impact on pricing as the demand/supply balance will be hit.

2 European service companies have an edge

On purely financial grounds, the incident in the Gulf of Mexico is, in a way, positive for oil prices and for all companies not directly involved. We have raised our stakes in cheap, well run exploration companies like Cairn, Premier Oil, Dragon Oil. We also remain overweighed on quality offshore operators like Statoil. Also, even stricter regulation will come in due time, impacting all regions. This will again raise costs and ultimately oil prices as projects with marginal profitability will not be sanctioned. It will also help quality service companies as oil majors will be less inclined to work with marginal low cost providers. Mergers will also follow as small companies will struggle to pay the higher insurance costs. Most European service companies have a natural advantage as regulations are tougher, especially in the Norwegian part of the North Sea.

3 Repercussions on the broad energy sector

With regards to the repercussions on the energy sector, the first impact will be a reduced exploration activity in the Gulf of Mexico for probably more than 6 months. Safety regulations will become stricter and minor delays may happen. Safety rules in many locations (e.g. Norway) are already much stricter than in the Gulf of Mexico. In the medium term, a further change in regulations and procedures is to be expected. This will raise the cost of drilling, might be positive for service companies as there will be more inspection, casing and cementing etc. to be done and it will ultimately lead to higher oil prices. Nevertheless, offshore will remain important going forward, as the world needs offshore oil and governments need the royalty income from it.

4 BP removed from SRI universe

With the sinking of Deepwater Horizon on 22 April 2010, the oil sector has catastrophically encountered its own version of “fat-tail risks”. These, statistically speaking, are the unlikely risks which wreak massive havoc when they do materialise. Dexia AM’s sustainability analysts have included this risk type in their analytical framework for the entire sector and expect that all companies in the oil sector will be forced to a fundamental review of their business model and safety procedures.

This unprecedented deep offshore well explosion happened to companies that are recognised as being among the best in the business. This accident will have critical consequences for the whole oil and gas industry worldwide, not only US but also Norway, UK, Brazil, West Africa etc. From an SRI standpoint, notably with regard to safety, it will entail higher risks associated with drilling at ever greater and more challenging ocean depths. This will lead to stricter regulations and thus higher costs for deepwater exploration and production, higher taxes in general and new relationships between majors and their oil service contractors/drillers.

Dexia AM’s sustainability analysts downgraded BP’s business model scoring because of the higher environmental risk associated with deepwater projects and the relatively high exposure of BP to deepwater projects compared to its peers. 14% of BP’s 2010 estimated production depends on deepwater exploration versus 9% on average for other oil majors.

The accident has also brought to light apparent deficiencies in BP’s day-to-day stakeholder management, such as inadequate safety measures to protect employees, installations and the environment, and poor interaction with contractors. In its American operations, especially, BP’s formal safety statements have, in practice, been ignored. Furthermore, the accident has severely damaged BP’s relations with the public authorities, on whose goodwill oil companies depend for their licence to operate. Therefore, Dexia AM’s sustainability analysts removed BP from their best-in-class SRI selection on 21 June 2010.

5 Summing it up

In conclusion, the oil spill is a disaster for the environment, and for the people who were (in)directly involved. It doesn’t change our oil price outlook however (positive on any medium term scenario) or the dynamics of most players in the oil industry, including the offshore industry. Our funds have adapted to the events in terms of stock picks. Energy is still a very interesting sector to invest in and as most companies have suffered over the last couple of weeks in the general market correction, valuations have become even more compelling. In addition, they are cash flow generating machines sporting dividend yields of more than 6% whose earnings momentum is on the rise. An example is Total, whose latest quarterly results were encouraging.

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Source: Thomson Reuters Datastream

Parlaying these still attractive investment fundamentals into a winning investment strategy can be done through Dexia Equities L Europe Energy Sector, which combines a healthy combination of high-quality energy and utilities stocks. The fund has an excellent track record in the short and longer term and boasts an experienced fund manager that is moreover supported by a team of specialised European fund managers.

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