



Insigneo Weekly Dispatch

# Oil and Some Ideas on how to Invest in this Industry

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## Oil and Some Ideas on how to Invest in this Industry

OPEC+, Saudi Arabia, Russia, China, basins in the United States and Argentina and pipelines. These are just some of the many topics that we hear about in the news that lead back to one thing: oil. So many variables can affect this commodity that it can sometimes be dizzying to try to keep up with what is going on in this market. After spending many years covering the sector as an Energy equity analyst at BNY Mellon, I can honestly tell you that it is a fascinating industry. However, truly understanding it took me many years. From numerous “teach-ins” as a young analyst with more seasoned Energy analysts at Goldman Sachs, J.P. Morgan, and Lehman Brothers (I’ve been around for a while), to visiting oil rigs miles into the Gulf of Mexico, understanding the ins and outs of the sector proved trickier than I expected. With this said, I thought I would spare you some of the leg work and try to add some clarity to the industry, as well as present some possible investment ideas that could be of interest for the appropriate investor.

It is true that there are a seemingly endless number of variables that can affect the price of oil, but at the end of the day, the vast majority of these come down to supply and demand dynamics. Supply and demand dynamics can be affected by different factors across different time periods, which is why it is critical to analyze this industry over both the short and long term.

In the short term, both supply and demand can sway in different directions, taking along with it the price of the commodity. We saw this dynamic play out when oil prices spiked after Russia invaded Ukraine, on fears of limited supply. We also saw oil prices decline earlier this year as Chinese demand for the commodity proved more elusive than expected. WTI, or West Texas Intermediate oil is used to quote prices in the United States, while Brent Sea oil is used to quote prices internationally. Since the beginning of 2020, we saw Brent oil prices drop from \$70 to \$20 per barrel, during the Covid-19 pandemic, rebounding and closing 2021 near \$80, spiking to close to \$140 in 2022, then settling back down to its current level of \$83.66. We believe that Brent oil prices could close the year above \$90/barrel and could potentially move above \$100 next year. But how many other assets see their prices drop by 70%, followed by an increase of 600%, followed by a subsequent 40% drop, in a little more than three years? That is oil for you over the short term, buffeted by countless and ever-changing variables. Trying to invest by timing these short-term moves could have yielded meaningful gains, as well as meaningful losses.

However, like with everything else in the investment world, keeping a long-term perspective is key. Oil, like most other commodities, is a cyclical industry. Over the past 20 to 25 years, oil has moved from the \$20/barrel range to the \$140/barrel range twice, roughly every 10 years, although a range between \$40 and \$120 per barrel has been more common over the same period. Investing in this cyclical sector near its long-term troughs and reducing exposure near its long-term peaks has proven to be a better strategy than attempting to time its short-

term fluctuations. The long-term nature of the cycle is also caused by shifts in supply and demand of the commodity. However, these long-term shifts are dictated by structural, not temporary changes.

Demand is likely to ebb and flow in the foreseeable future. Although we are seeing oil demand slow in the developed world, it remains strong in emerging markets, particularly in countries like India and China. However, it is a structurally constrained supply scenario that keeps us bullish on oil over the long term. An increased focus by producers on capital discipline, underinvestment in production resources, and political pressures are likely to keep production growth muted through the current cycle. Production cuts by OPEC have led supply to 6-year lows while production and transportation capacity continues to remain limited. Constrained pipeline networks across the United States are leading to mergers between midstream companies in the country in an attempt to gain scale, as evidenced by the recent acquisition of Magellan Midstream Partners by Oneok Resources.

In addition to favorable supply and demand dynamics, valuation also appears to favor the Energy sector. Companies in capital intensive sectors such as Energy are best evaluated through the lens of the EV/EBITDA ratio. Using the S&P 500 Index Energy sector as a proxy, we can appreciate the sector's valuation discount. Based on this observation, the Energy sector currently trades at an EV/EBITDA of 5.74x, more than 20% below its 10-year average valuation of 7.2x. We believe that the structural imbalance of supply and demand, coupled with attractive long-term valuations, could create a potentially attractive investment

opportunity for an investor with a long-term horizon. The logical question revolves around how to invest in the sector, and below we present some potential ideas.

**Energy Select Sector SPDR ETF (XLE)**: With a low expense ratio of 0.10%, the Energy Select Sector SPDR ETF is a great way to gain exposure to mostly Large-Cap energy production companies in the United States. Integrated oil majors such as ExxonMobil, Chevron, and ConocoPhillips form the backbone of this ETF, along with refinery companies such as Valero, and oil service providers such as Schlumberger. This ETF provides a diversified vehicle through which to gain exposure to this industry.

**VanEck Oil Services ETF (OIH)**: Another ETF that could be considered is the VanEck Oil Services ETF. The XLE ETF above focuses mostly on the producers and refiners of oil and gas. OIH focuses on the companies that service these producers. Companies like Schlumberger, Haliburton, and Baker Hughes provide services such as drilling equipment, crews, drilling rigs, and other products and services used to make an oil and gas well productive. Given where we are in the energy cycle, we believe that the oil service subsector will also benefit from increased oil prices, as these naturally lead to increased costs of production. OIH carries an expense ratio of 0.35%.

An investor with a higher tolerance for risk that would like gain access to the sector through individual stocks could consider the following companies:

**Integrated Producers: Shell PLC (SHEL), BP PLC (BP), ExxonMobil (XOM), Chevron Corp (CVX)**.

These four enterprises are globally diversified energy companies with production and refining assets throughout the world. All four are leading global producers with large earnings and cash flow generation. Additionally, SHEL and BP are also focusing on developing sustainable and green energy assets such as blue hydrogen and LNG.

**Oil Services: Haliburton (HAL), Schlumberger (SLB), Baker Hughes (BKR)**.

These three companies have well diversified revenues streams, as they offer services on a global scale to end customers ranging from larger Super Majors to small Exploration and Production companies. They continue to benefit from increased spending as well as capital discipline from producers. What this means is that although producers are facing rising costs, they are also being cost-conscious of how they allocate their capital spending. Large, diversified oil services companies benefit from this dynamic, as they have pricing power and can better accommodate the particular needs and services required by their customers.

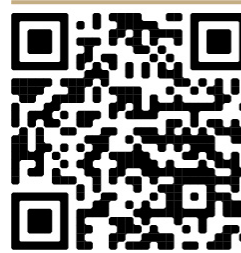
**Latin American Energy Ideas: YPF (YPF) and Vista Energy (VIST)**.

Both of these companies could continue to be long-term beneficiaries of the development of the Vaca Muerta oil formation, which lies predominantly in Argentina. Additionally, both companies could see their costs of production continue to decline, as production practices in the region shift from conventional to horizontal drilling. It is important to keep in mind that, in addition to the different risks associated with the Energy sector, these two companies are susceptible to

political risks in the region, particularly surrounding Vaca Muerta, and would be best suited for investors with a high tolerance for risk.

As always, it is also important to consider that the individual equities mentioned here can exhibit high degrees of volatility and are not suitable for every investor. These investments are best considered on a case-by-case basis, based on a particular investor's willingness and ability to tolerate risk. If you need more information or would like to discuss these or other potential ideas in more detail, please

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