10 Key Things You Must Know Before Buying Oil Stocks

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Introduction – the bull and bear opposite with oil

I've recently done a video on investing and the corona virus where I asked viewers to comment on what stocks they wish me to analyze. The overwhelming number of comments asked for oil stocks analyses with aviation coming in second. As I am intrigued myself both about the oil situation and aviation as long-term investing opportunities, I've decided to look into the sectors and try to add value by answering the question whether oil and aviation stocks are an opportunity or the risk is too high related to the upside. With this article I'll start with oil stocks analysis.

During the analysis of the sector, 10 key investing factors came to my mind that are crucial when it comes to investing. I hope you enjoy this oil sector analysis and related investing education.

Disclosure: I am long oil and gas already with part of my portfolio. I have to see what to do with that and that is the main goal of my analysis. If you wish to check my portfolio, please do so here.

Investing in the oil sector outlook

The diverging situation when it comes to oil is the following:

- Most of us still use it on a daily basis as the number of electrical cars on the road is minimal. But,
- sentiment related to climate change, emissions, oil, fossil fuel, laws etc. is strongly turning against oil and therefore there might be a structural shift ahead. What would be the implications of such a structural shift? Well, think about horses and how those fared when cars came.

Table 1
U.S. Equine Population During Mechanization of Agriculture and Transportation

Year	Number of Horses and Mules
1900	21,531,635
1905	22,077,000
1910	24,042,882
1915	26,493,000
1920	25,199,552
1925	22,081,520
1930	18,885,856
1935	16,676,000
1940	13,931,531
1945	11,629,000
1950	7,604,000
1955	4,309,000
1960	3,089,000

Source: Adapted from Ensminger (1969).

The demise of the US equine population - Source: Human Society

The above is something that could happen to oil over the next years and if that happens, the investing situation might be really ugly. To show you how bad it can get and to use a more recent example than horses, we have seen what a structural shift means with coal already.

Coal ETF is down 80% since 2011 (I will add coal on my sector analysis list, now that it is forgotten might be the best time to look)

But, on the other hand, the global economy is growing, the population is increasing and demand for oil might continue to grow. In that case, oil stocks could be cheap. To quote XOM's CEO Darren Woods from the Q4 earnings conference call:

"We know demand will continue to grow driven by rising population, economic growth and higher standards of living."

So, who will be right? Well, that is something nobody knows. The fastest way to lose money is to be certain about something where the outcome is uncertain. However, we can try and attach probabilities to outcomes, look at fundamentals and figure out at what price, what level and with what strategy, could an oil stock be an interesting, low risk, high reward investment. Let's take a look at current situation and the long-term outlook.

1st TAKEAWAY: INVESTING IS ALWAYS WITH UNCERTAINTY AS WE CAN'T KNOW THE FUTURE! WHAT WE CAN DO IS FOCUS ON FUNDAMENTALS IN ORDER TO LOWER OUR RISK AND INCREASE OUR REWARD. IF YOU ARE NOT HAPPY WITH THE RISK AND REWARD, say NEXT. IT IS ABOUT RISK AND REWARD, NOT ABOUT KNOWING THE FUTURE.

The current situation with oil – short term opportunity but where is the bottom?

Over the past month, oil prices have fallen significantly as the Chinese economy will likely slow down due to the coronavirus. The Chinese economic slowdown implies less demand for oil and consequently oil prices are lower. However, such severe ups and downs are normal for oil as oil prices and many oil stocks are highly volatile.

1 Year oil price – Source: [CNN Money]

However, when I look at oil prices form a longer-term perspective, oil prices tend to fall whenever there is fear about a global economic slowdown in the short term or when there is a long-term structural shift.

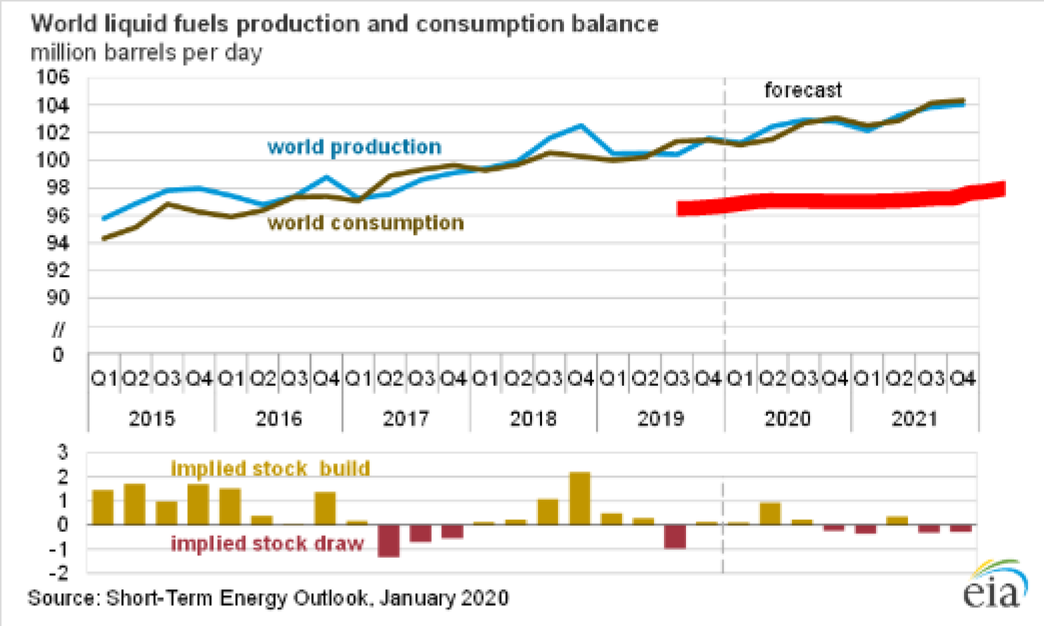
10 Year oil price – Source: [Tradingeconomics]

The 2014 to 2015 drop in oil price was the first structural shift hitting oil – it became clear that shale oil will lead to oversupply and lower average oil prices. Since 2015, prices have stabilized around $50 but other structural shifts might change that.

One thing I am sure of, to paraphrase J.P.Morgan, Oil prices will fluctuate.

However, the fluctuation depends on current happenings that impact the short-term supply and demand. Making money on short-term movement is pure speculation. Real investors have to see about the long-term structural forces and average oil prices based on supply, demand alongside OPEC and Russia curtailing production.

The U.S. Energy Information Administration is neutral on oil and predicts no shocks or structural shifts in demand or supply.



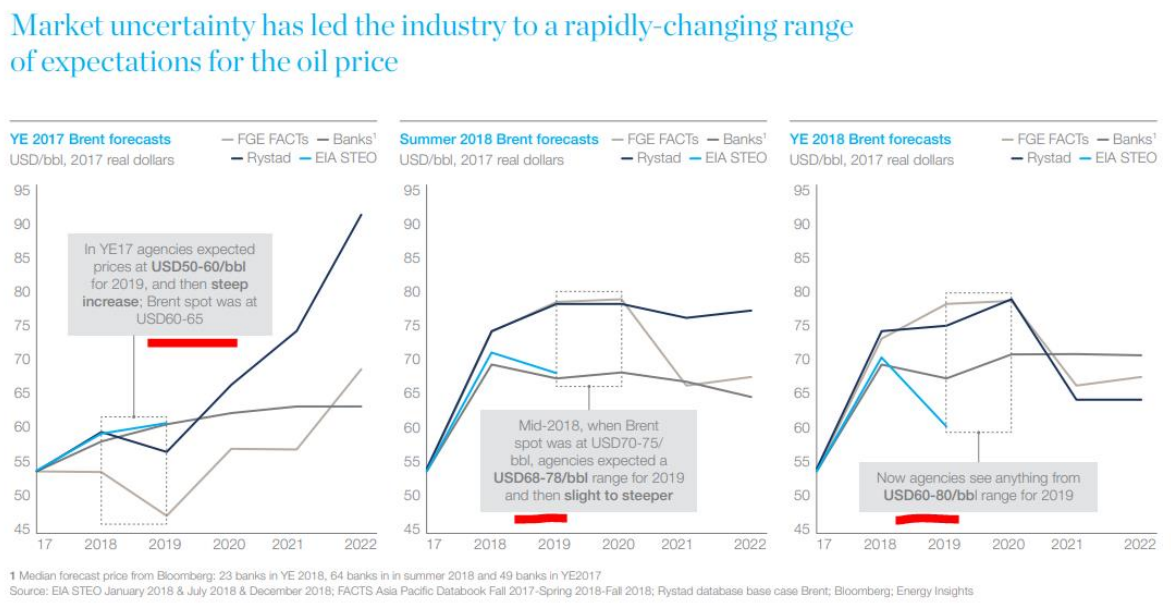
Oil demand and supply – Source: EIA

Let's take a look at the long-term implications for oil.

2nd TAKEAWAY: VOLATILITY EQUALS OPPORTUNITY – BUT IN ORDER TO LOWER YOUR RISK AND INCREASE YOUR RETURN, YOU NEED TO FOCUS ON FUNDAMENTALS. AT SOME POINT OIL PRICES AND STOCKS WILL BE SO CHEAP THAT THERE WILL BE HUGE BARGAINS.

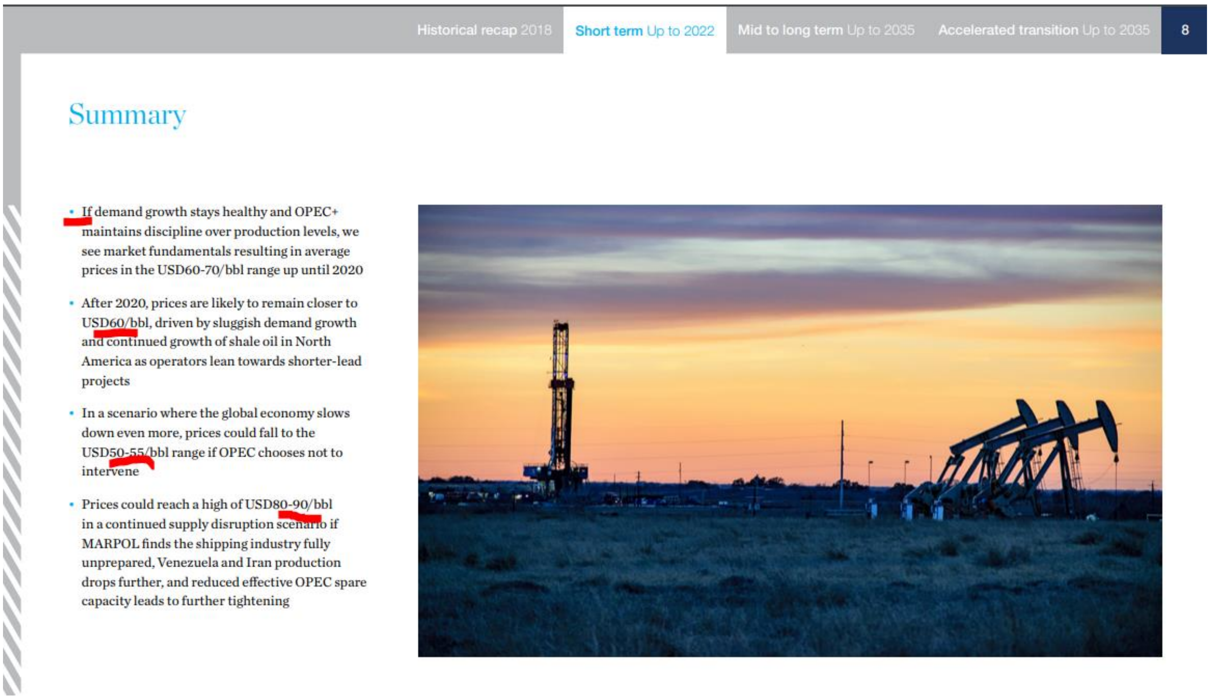
Oil long-term forecasts and fundamentals

A thing to note is that not even professionals know what will happen with oil long-term. McKinsey shows a nice chart on how analysts' expectations changed over the last few years. In 2017 agencies expected prices between $50 and $60, in 2018 between $68 and $78, in 2019 between $60 and $80 while probably in 2020 they will drive expectations down due to lower current prices. Thus, nobody knows and most just try to follow the market in place of predicting it.



Oil price forecasts - Source: [McKinsey]

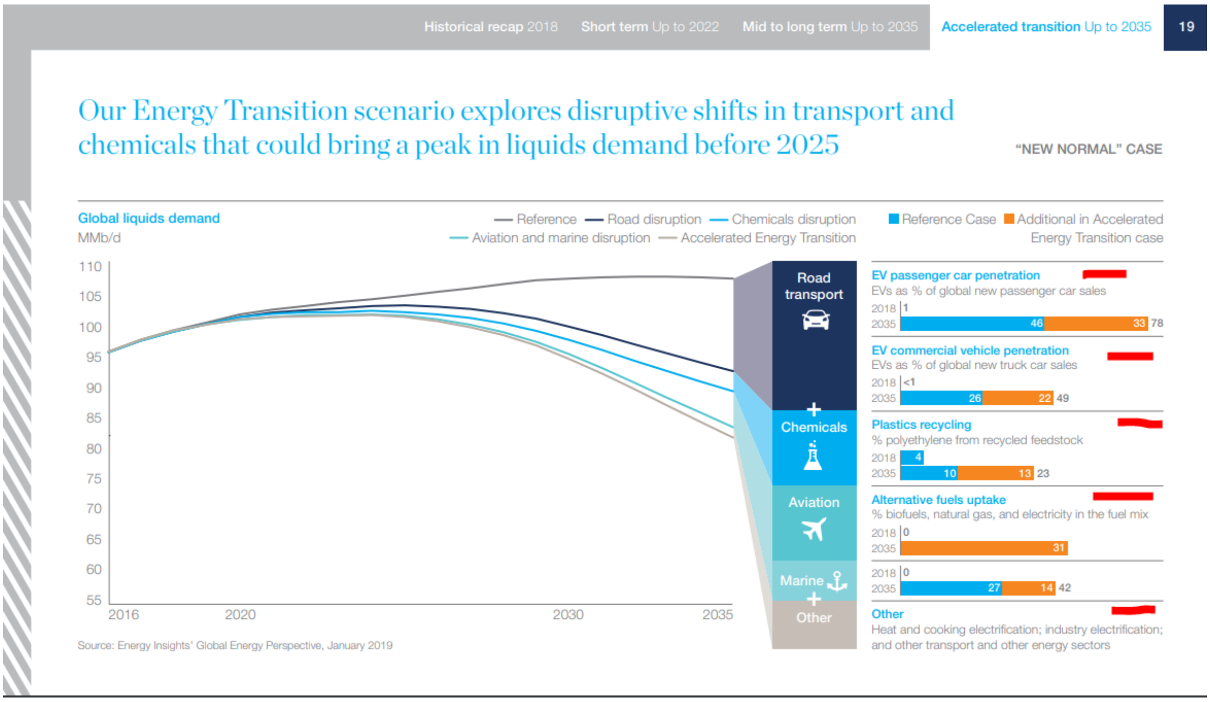
Similarly, their summary for up to 2022 doesn't tell you anything. If demand stays strong, expect $60, if not expect $50, if there is an oil crisis expect $90.



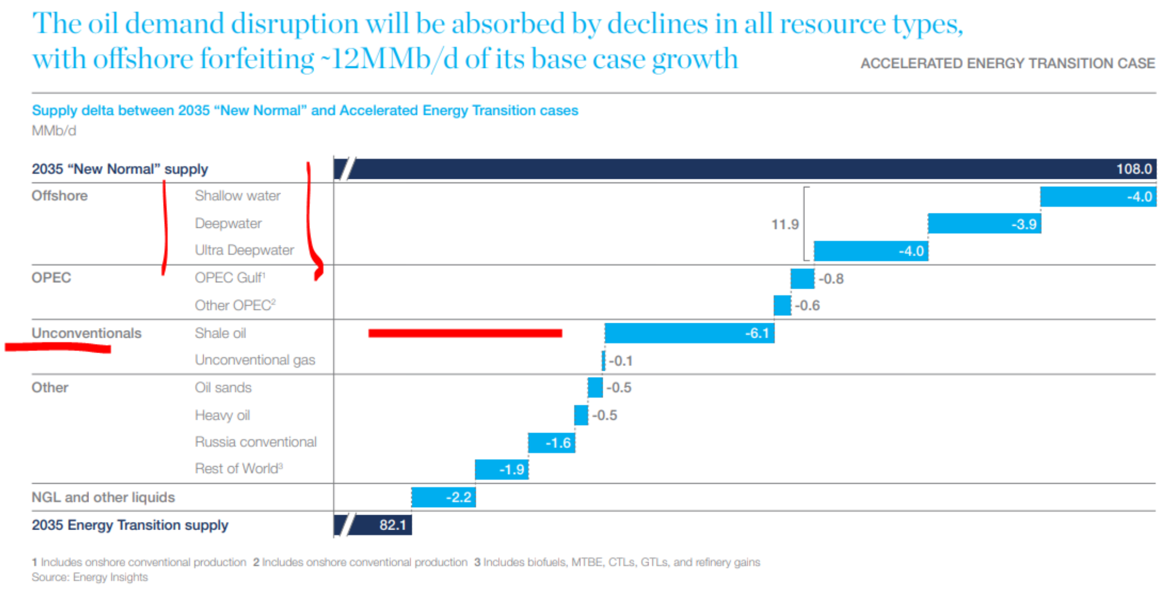
If they can't predict anything over a few years, how could anybody predict anything over the next decade? Perhaps the key of this analysis is that you shouldn't even expect it to be possible to predict something like that over the next decade.

The thing is that if there are technological disruptions and demand peaks prior to predictions (2030) oil prices will inevitably go below $40.

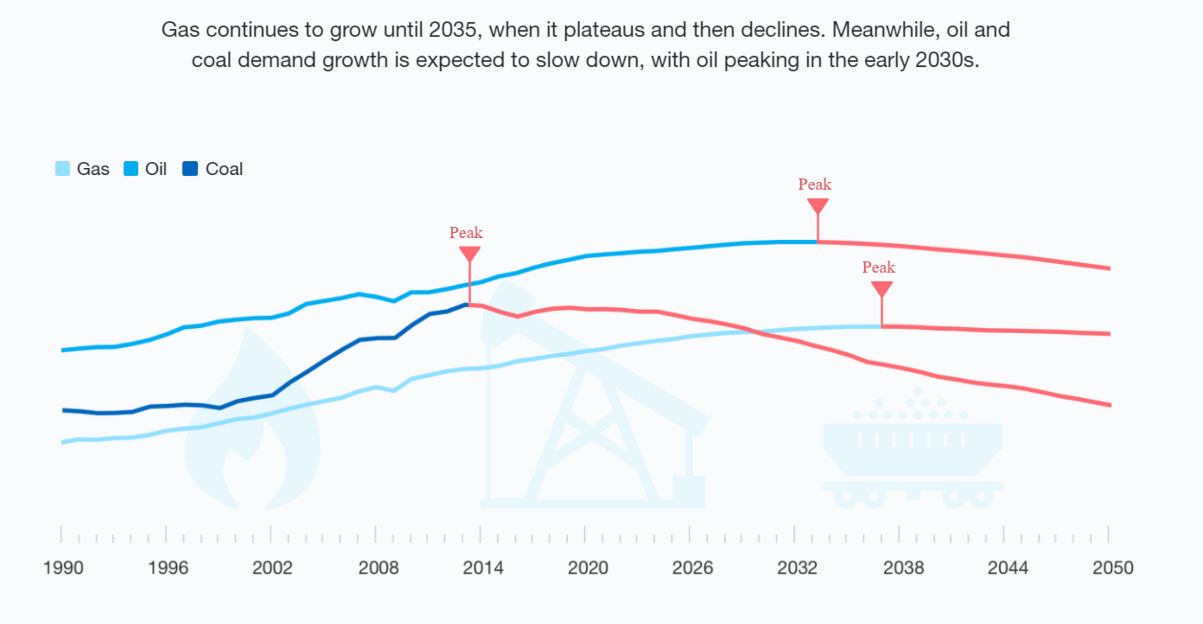
What McKinsey discusses as 'alternative scenario' is actually what we are seeing happening already. EVs are used more and more, recycling is trending and growing fast, there are alternative fuels and I don't even see McKinsey mentioning renewables. Emerging markets are strongly focused on lowering emissions due to pollution and might completely skip the oil phase in development.



If that happens, the biggest losers will be the producers with highest cost like offshore and shale oil because there will always be demand for oil. It is just that small changes in demand are very significant.

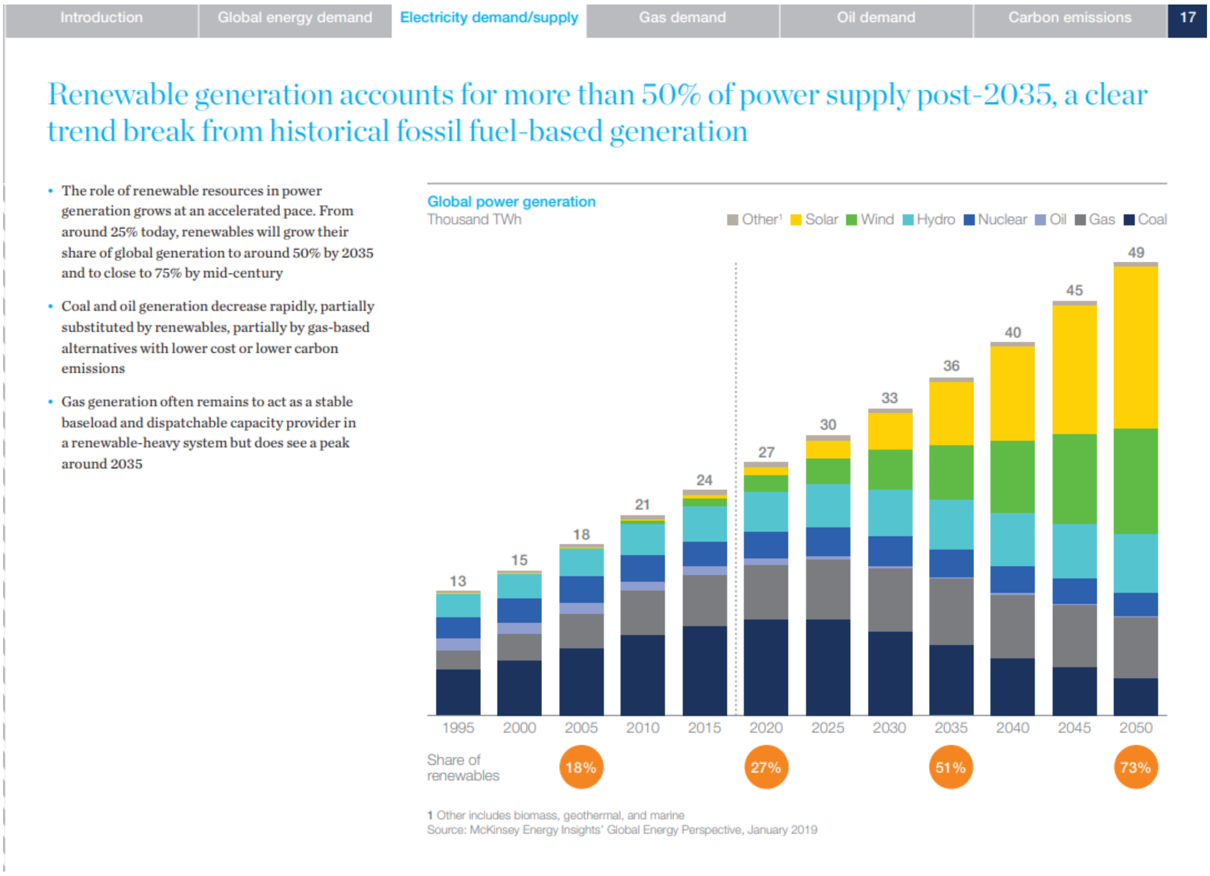


If oil peaks, with CEOs sure about growing future demand, increasing production, the market situation for oil will be terrible, like it has been for coal. With all CEOs projecting production growth, the supply glut ahead might push oil prices below $20.



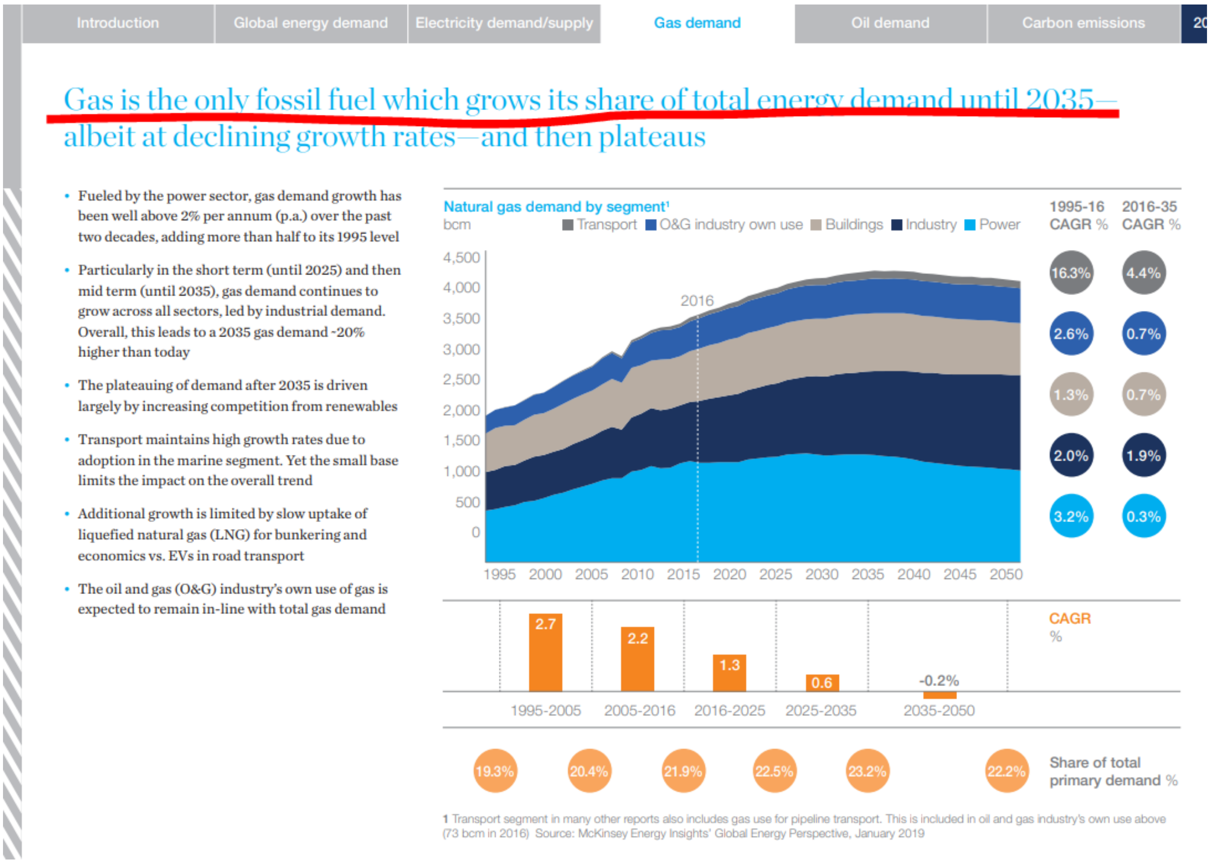
Oil, coal and gas peak forecast - Source: [McKinsey]

From an energy mix perspective, many analysts must think linearly because if you are an analyst and you don't think like others, you lose your job. If you make a mistake but others did it too, you are ok. Therefore, it is nice to make predictions, but what if things move faster than what a well-trained linear mind can comprehend?



Global energy outlook (linear mode) – Source: [McKinsey]

Gas is the only fossil fuel to likely grow over the next decade as you need to power those generators to make electricity.



Global gas outlook (linear mode) – Source: McKinsey

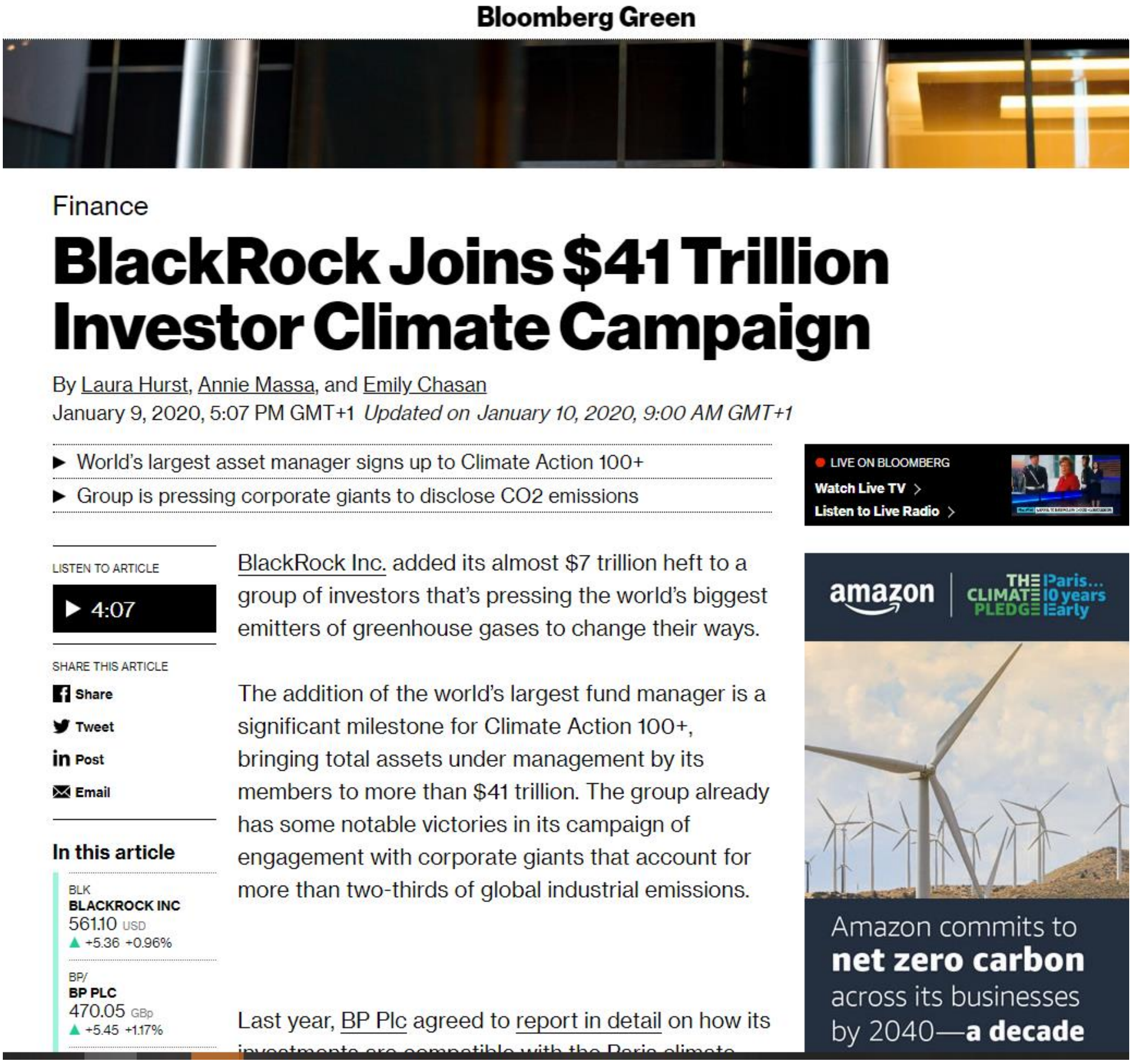
3rd TAKEAWAY: INVEST ALONGSIDE STRUCTURAL TAILWINDS OR BE EXTREMELY WELL REWARDED FOR TAKING THE STRUCTURAL HEADWIND RISK – INVESTING ALONSIDE TAILWINDS CORRECTS MISTAKES. BETTING AGAINST STRUCTURAL SHIFTS EXERBERATES MISTAKES.

Before digging into how to invest, let's take a look at sentiment which is the most important thing when it comes to markets and short-term volatility.

Oil investing sentiment

As oil prices fell since 2010, investors lost money and that is not something good. So, what do asset managers do? They change how they work and what they own. BlackRock lost $90 billion on oil and coal over the past decade and after initial public pressure, decided to ditch investing in the sector.

If less money goes to such investments, we know what will happen to the stocks.


Bloomberg Green

Finance

BlackRock Joins $41 Trillion Investor Climate Campaign

By Laura Hurst, Annie Massa, and Emily Chasan
January 9, 2020, 5:07 PM GMT+1 *Updated on January 10, 2020, 9:00 AM GMT+1*

- World's largest asset manager signs up to Climate Action 100+
- Group is pressing corporate giants to disclose CO2 emissions

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BlackRock Inc. added its almost $7 trillion heft to a group of investors that's pressing the world's biggest emitters of greenhouse gases to change their ways.

The addition of the world's largest fund manager is a significant milestone for Climate Action 100+, bringing total assets under management by its members to more than $41 trillion. The group already has some notable victories in its campaign of engagement with corporate giants that account for more than two-thirds of global industrial emissions.

Last year, BP Plc agreed to report in detail on how its

BlackRock committing to climate change – Source: [Bloomberg](#) (note the Amazon advertisement too)

Goldman also [downgraded](#) companies like XOM on lower than expected returns on invested capital.

Goldman downgrades Exxon to 'sell', slashes returns outlook

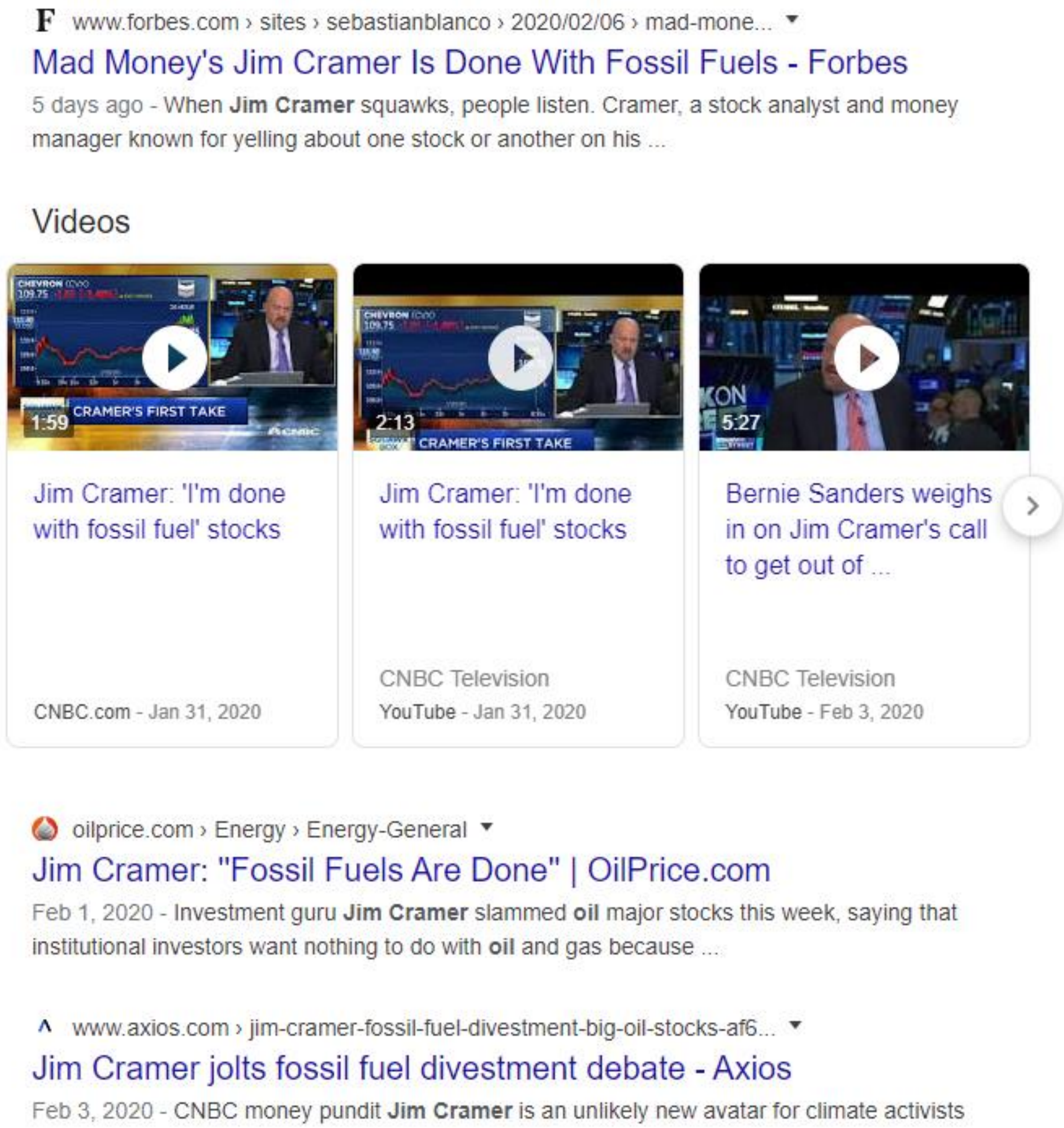
2 MIN READ

LONDON (Reuters) - Goldman Sachs downgraded ExxonMobil (XOM.N) to “sell” following disappointing fourth-quarter results, as the Wall Street bank forecasted the oil and gas company will meet only half of its targeted returns by 2025.

4th TAKEWAWAY: WAIT FOR SENTIMENT TO BE EXTREMELY NEGATIVE, FOR BLOOD ON THE STREETS – THEN HAVE THE CONFIDENCE TO BUY BASED ON STRONG FUNDAMENTAL ANALYSIS.

FOR THAT, SUBSCRIBE TO SVEN CARLIN, AS I’LL GIVE YOU THE COURAGE TO BUY WHEN YOU’LL MOST LIKELY WISH TO SELL

Some are saying they will never invest in fossil fuels again, which is a good start to find bargains, but mind structural trends and fundamentals.



Not yet, not yet – focus on the fundamentals not the relative story

Many see stocks down, relatively cheap when compared to the rest of the market but from a risk reward perspective the time is not right yet. Too much risk for little upside. Why little upside? Because the best investments are those that have infinite upside, that will give you dividends for as long as you live and beyond. Oil stocks are unlikely to do that as reserves are constantly depleted, new resources have different production costs, sanctions can always happen, the competition doesn't sleet etc.

The only time to invest in oil stocks is when those are really cheap. By really cheap I see a 2016 scenario will oil at $30. When we see that, I'll be happy to dig into oil stocks in lack of better opportunities.

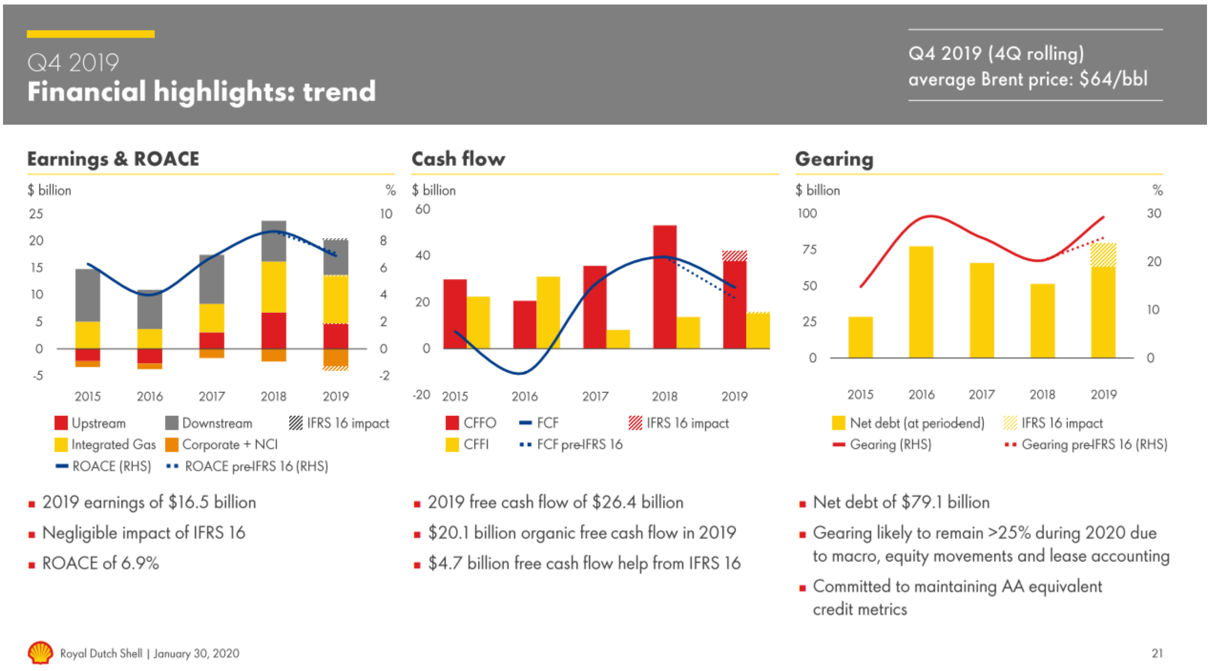
Further, I firmly believe it is better to invest in sector with tailwinds rather than headwinds. Copper is an example of such a sector as if the world electrifies, it will need more copper, alongside all the common needs for the red metal.

Oil stocks fundamentals

A stock that was highly required for me to analyze is Royal Dutch Shell (RDS). That is logical due to the low PE ratio of 13.22 and high dividend yield of above 7%.

The stock was severely hit lately as oil prices dropped and the outlook for 2020 wasn't spectacular alongside lower than expected earnings in Q4 2019.

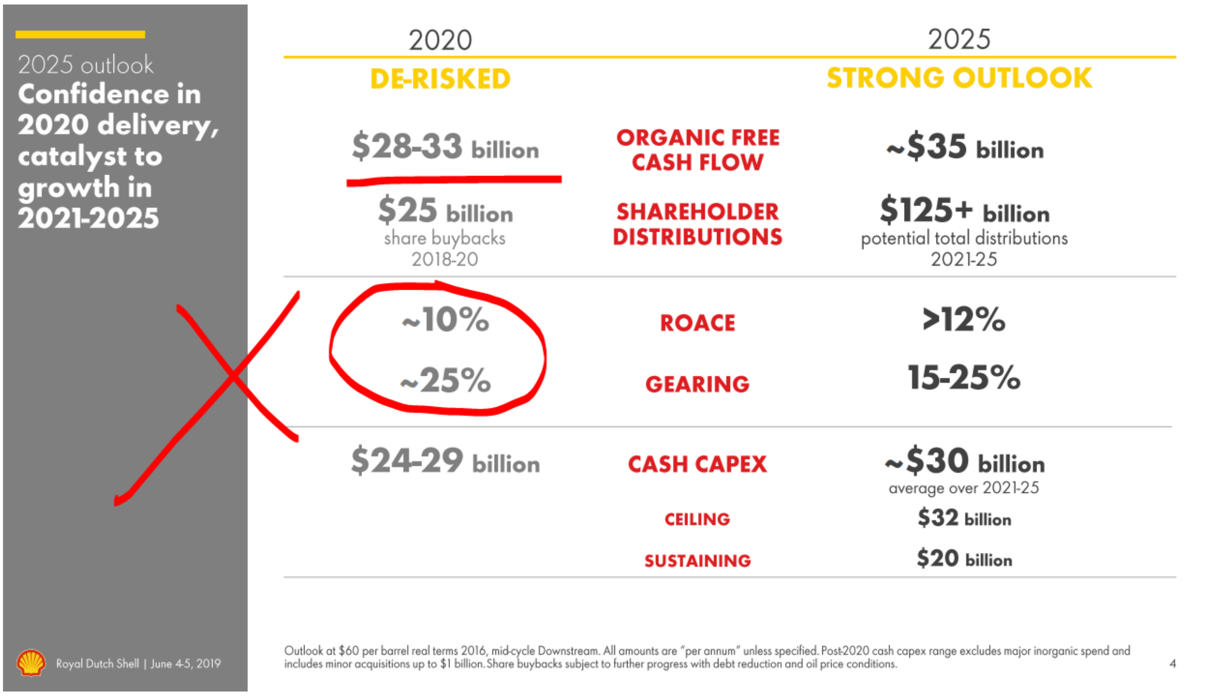
We can explain the company by looking at just one chart.



Return on average capital employed is low and has been 6.9% in 2019. If oil prices remain weak it will be even lower in 2020 and the company will not have enough cash to pay the big dividend and do the promised buybacks. Keep in mind that buybacks are a terrible thing when done on declining earnings, then buybacks emphasize the decline, especially if it comes to losses.

Nevertheless, earnings of $30 billion, free cash flow of $26 billion, or $20 billion organic, on a $200 billion market cap is a 10% yield. However, if oil prices decline and stay lower for a while, it can quickly go to $10 billion and less, when you have just a 5% yield. That will simply depend on oil prices.

Their projections are simply not materializing and there is absolutely no guarantee those will materialize in the future.



Source: [Management day 2019]

The thing is that if oil prices aren't at $60 as expected, the FCF goes down but the capex remains.

2025 outlook

Capital allocation to grow cash flow through 2025 and beyond

$ billion per annum	2020 Organic FCF (IAS 17)	2021-25 Sustaining cash capex (IFRS 16)	2021-25 Total cash capex (IFRS 16)	2025 Organic FCF (IFRS 16)	2025 ROACE %
Conventional Oil & Gas	5 – 6	4.5	4 – 5	5 – 6	
Deep Water	6 – 7	4	4 – 5	7 – 8	
Shales	1 – 2	2.5	3 – 4	2 – 3	
Core Upstream themes	**12 – 15**	**11**	**11 – 13**	**14 – 17**	**12-14%**
Integrated Gas	8 – 10	4.5	6 – 7	9 – 10	
Chemicals	0	1	3 – 4	2 – 3	
Oil Products	6 – 7	3.5	5 – 6	8 – 9	
Leading Transition themes	**14 – 17**	**9**	**14 – 16**	**19 – 22**	**11-15%**
Power	(2) – (1)	0	2 – 3	(2) – (1)	
Emerging Power theme	**(2) – (1)**	**0**	**2 – 3**	**(2) – (1)**	**8-12%**
Total	**25 – 30**	**20**	**Average ~30**	**~35**	**>12%**

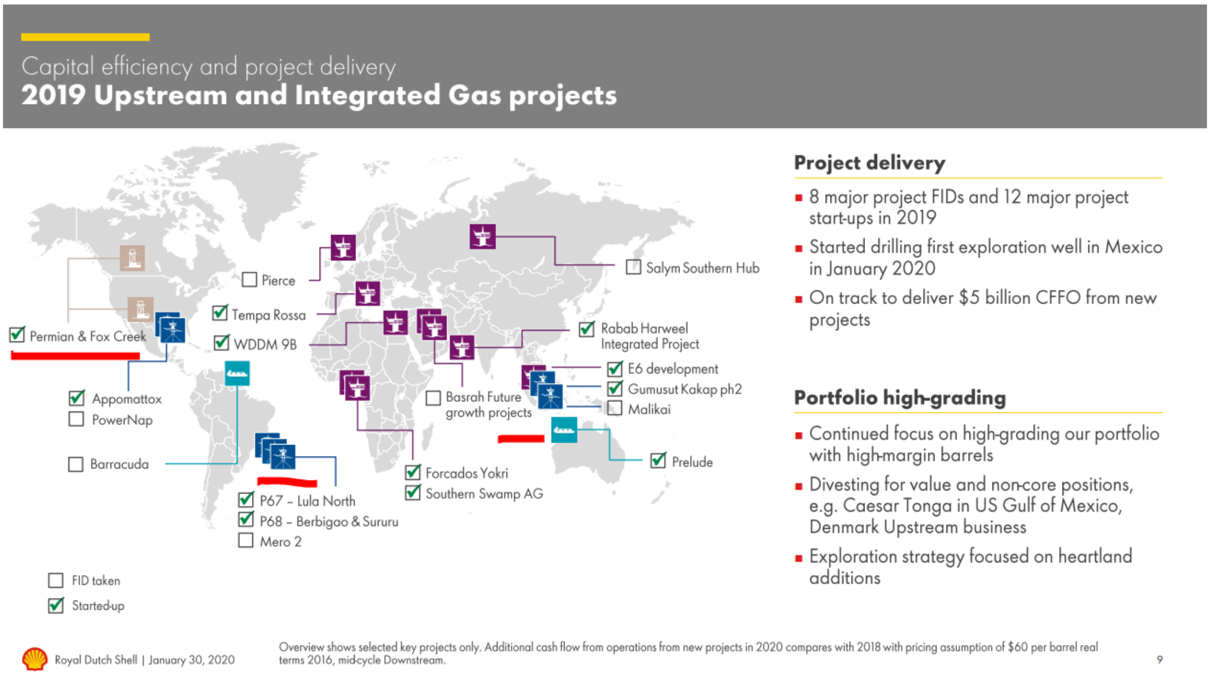
Outlook at $60 per barrel real terms 2016, mid-cycle Downstream. Post-2020 cash capex range excludes major inorganic spend and includes minor acquisitions up to $1 billion. Total cash capex capped at the top of range indicated for each strategic theme grouping. Power returns of 8-12% represent returns for on-stream integrated power business, ROACE for Power business (including development stage costs) expected to be around 6%.

Royal Dutch Shell | June 4-5, 2019 11

With revenues close to $400 billion, a small change in oil prices where we have seen in 2019 that oil prices are common to drop 40% in a year, erases all the hoped $30 billion cash flows per year.

Given the environment with oil, I would aim for a $15 billion FCF rate per year up to 2025 on a conservative basis, then $10 billion as less and less oil projects are profitable in line with the upcoming technological shift. When cash flows start declining, so will the stock price.

Plus, the issue with Shell is that it has only 8 years of resources left; thus, it will have to heavily invest into new projects. And their projects don't seem the most cost efficient to me.

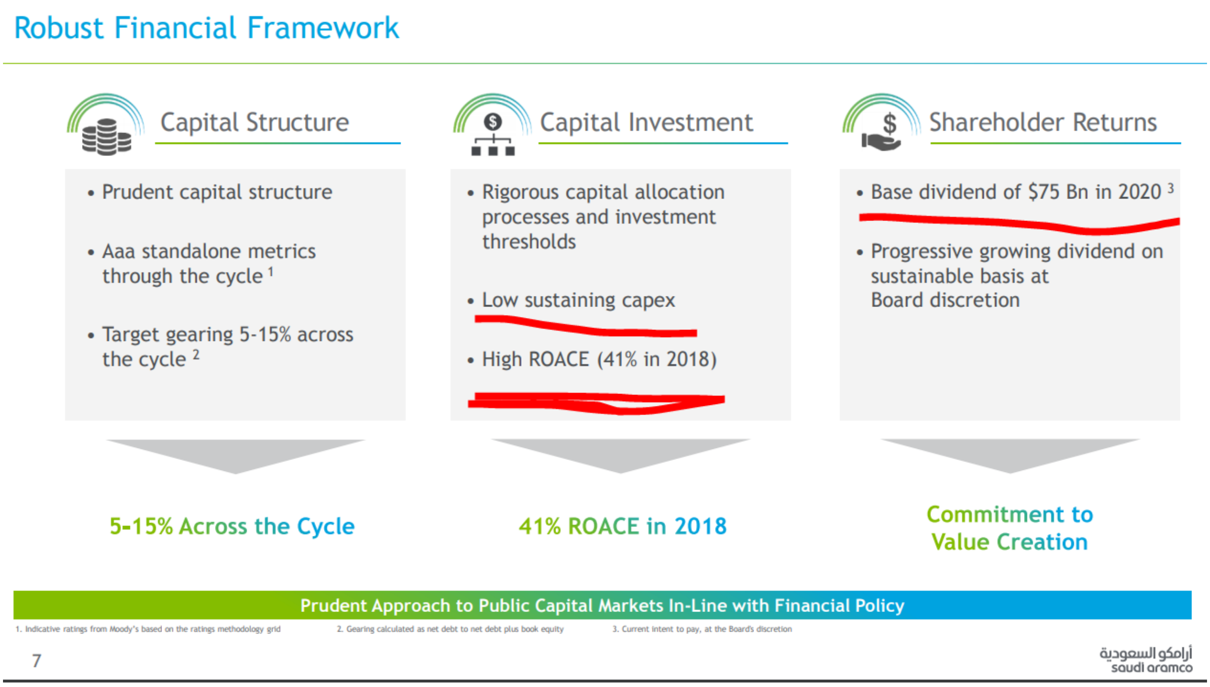


Anything can happen, but it is simply too risk. I have no idea how will Shell look into 2030, and I don't like to invest in something that is so risky, no matter the dividend. Keep in mind leverage went from 20% to 29% during 2019 despite the high oil prices.

If oil prices are lower, margins are thinner, profit warnings and dividend cuts are followed y downgrades, downgrades are followed by lower credit ratings and higher debt costs. You can always find yourself with a spiral of bad news in a sector with tailwinds.

5th TAKEAWAY: CHECK THE MOVING PARTS THAT MATTER BEFORE INVESTING – MOVING PARTS ARE ROACE (return on average capital employed), CASH FLOW, MARGINS AND AVERAGE CYCLICAL RESULTS – HOW DOES IT LOOK LIKE WHEN THINGS ARE BAD AND HOW WHEN THINGS ARE GOOD!

Compare Shell's ROACE and margins to Saudi Aramco. Saudi Aramco has a return on average capital employed of above 40%, while Shell has 7%.



Saudi's margins are 30% on net income while Shell is happy to get to 5%.

So, natural fundamentals are extremely important when it comes to investing. On one hand, those offer stability if the margins are high, but also less upside in case of much higher oil prices. However, given the OPEC's power to regulate their profits with production cuts or increases, it is hard for others to compete.

6th TAKEAWAY: LEARN WHO IS THE BOSS IN THE SECTOR – THEN COMPARE WHAT YOU HAVE WITH WHAT THEY HAVE – HAVE YOUR INTERESTS ALLIGNED FOR LONG-TERM INVESTING SUCCESS

Oil companies investing in renewables

To explain the risk of investing in oil, just look at Total's investor presentation cover page – it is not about oil, it's about solar. So, the company is practically telling us the future is not where their main business is so that they can look cooler. But then they invest and 99% of their business is still and will be oil and gas.

Source: Total

We have already quoted XOM's CEO on how demand will grow in the long-term, but don't trust stories when it comes to investing, always focus on fundamentals.

In that line, also know the intentions of the owners you are investing along. Chinese government owned companies are about Chinese growth, not that much about your benefit as a shareholder.

Business / Companies

Sinopec tumbles on surprise sale of HK$24b shares at huge discount

Stock drops 6.4 per cent after the oil-refining giant upsets the market by selling HK$24 billion of shares to select investors at a big discount

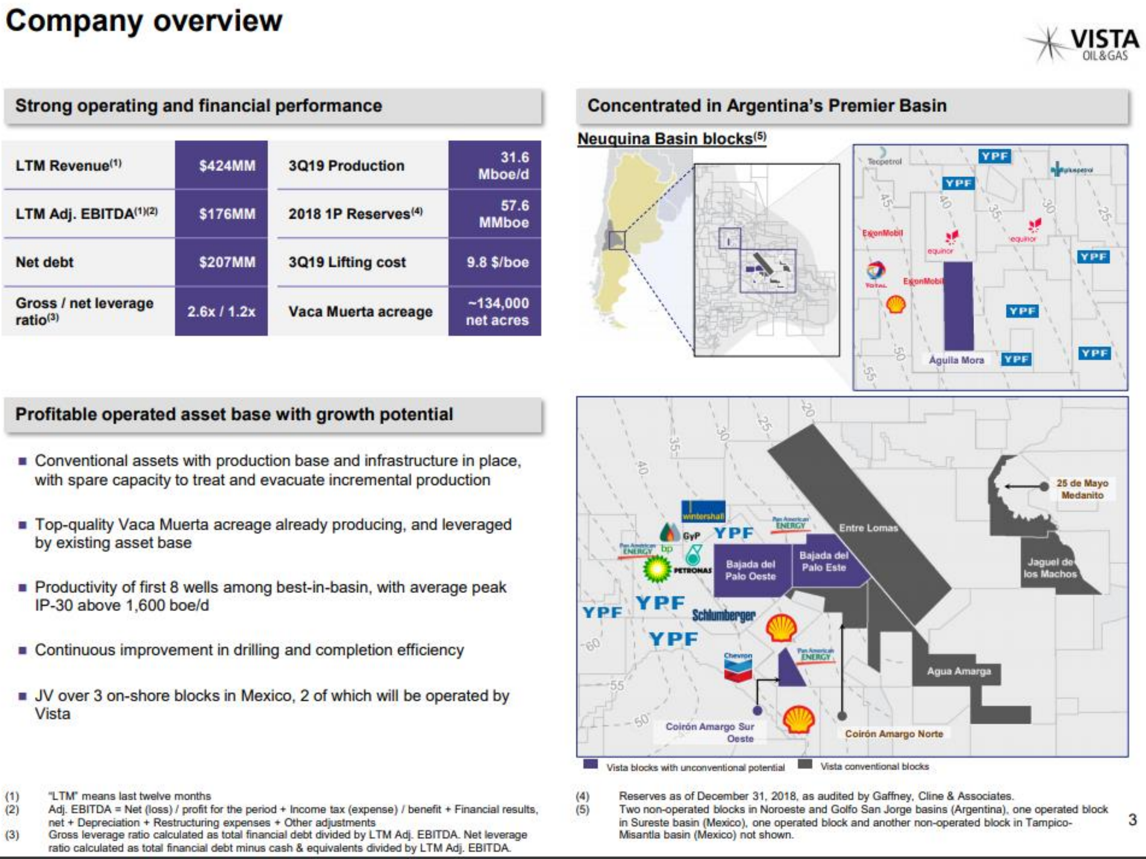
7th TAKEAWAY: CEO's ARE SALESMAN. THEIR JOB IS TO SELL THEIR STORY, BUT WE MUST NEVER INVEST IN THE STORY, WE MUST INVEST IN FUNDAMENTALS, MOATS, GREAT BUSINESSES.

At the end, it is always about fundamentals.

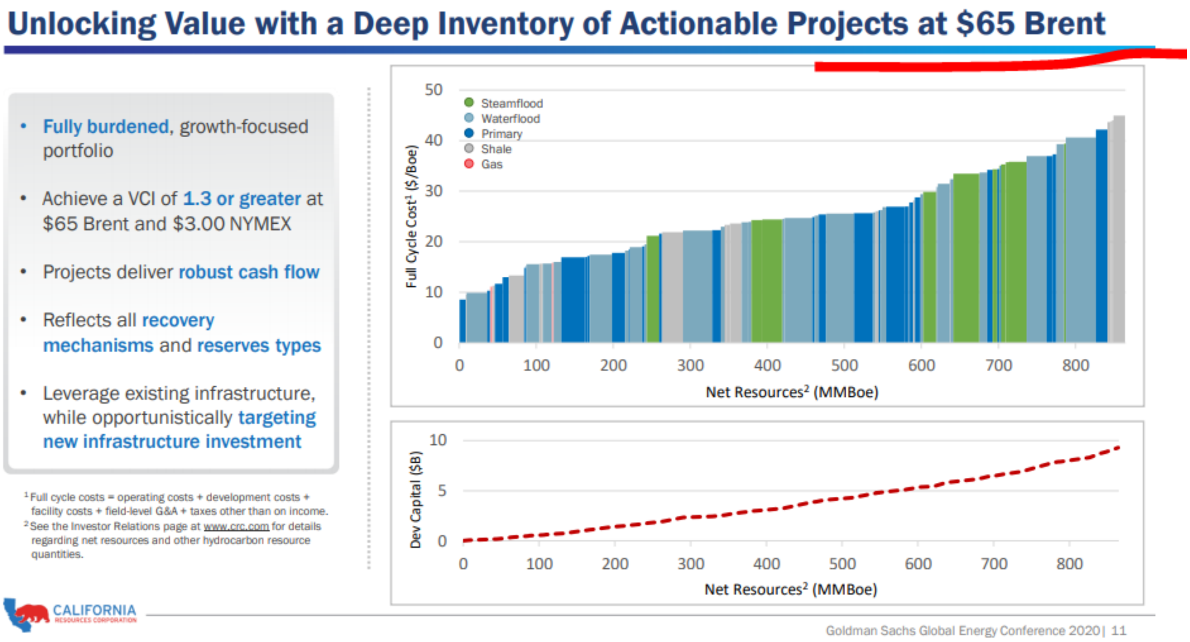
Oil fundamentals – production costs is key

Source: [Schlumberger]

This excellent chart from Schlumberger shows where the costs are lower as the number of rigs is in stable increase despite the oil price drop in 2014. Therefore, keeping the structural shift in mind, one must focus on fundamentals and keep in mind the risks of alternative options like Vacca Muerta in Argentina where Vista Oil and Gas is developing fields in Argentina. Those are not proven yet economically but might be, therefore the risk is high and possible reward too.

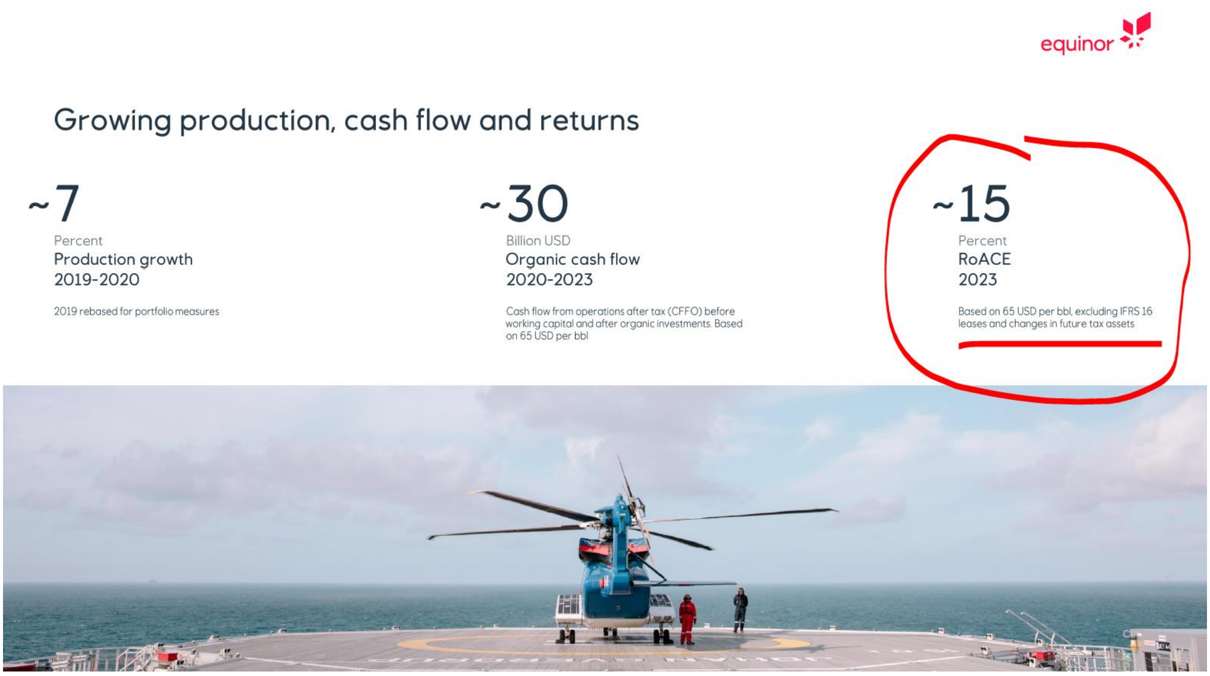


A similar situation is for California Resources aiming to grow oil production in California with a 4-fold risk; oil prices, drilling legislation, debt and resources.



Source: [California Resources Investor relations]()

The thing is you have to be an absolute investor, not a relative one. Relative investors take too much macro risk. Equinor hopes to get a return on capital of 15% but that will only be reached if there are no surprises and oil prices are at $65. On the other hand, if many have $65 oil as their benchmark for growth, it might be the case oil is already cheap. However, it might get cheaper but it is so much easier to invest in great businesses rather than cheap ones.



8th TAKEAWAY: FOR ME, INVESTING IS ABOUT GREAT INVESTMENTS AND YOU CAN WAIT FOR A LONG-TIME TO FIND THEM BECAUSE IT IS WORTH IT. A COMPOUNDER WILL GIVE YOU DIVIDENDS FOR ETERNITY, A CHEAP STOCK IS SOMETHING YOU MIGHT GET STUCK WITH FOR A LONG TIME.

Buffett didn't invest in oil

I recently received an email that Occidental Petroleum has a yield the same as what Buffett is getting for his $10 billion loan to Occidental.

Well, Buffett lent money to the company at an 8% interest rate, alongside receiving many warrants that give him all the upside and little downside as his bonds give him much more protection than what shareholders have.

9th TAKEAWAY: Buffett is simply doing what we all should do: MINIMIZE RISK, MAXIMIZE REWARD

My conclusion on investing in oil

I am long a gas/oil stock, and I am long a partial oil stock. I like those because the PE ratio when I bought was 3 on the first one and with the second one oil is just some possible upside and not even regarded by analysts as a factor, yet. So, I am positioning myself in low-risk, high upside investments.

As for the predominant oil stocks discussed here, the risk is high given the possible but uncertain structural shifts ahead. The question isn't that much about what will oil stocks do as it is about what do you wish for in your portfolio?

- Do you want great companies that give the possibility to compound for eternity? Or,
- Do you want relative bargains that depend on how the market or industry moves (oil stocks)?

Focusing on the former requires a lot of patience and hard work. It isn't exciting as you don't find something to buy on a monthly basis, and I have a feeling many of you expected me to jump into buying some cheap oil stocks, to give you some action as 'oil stocks are down with high dividend yields'.

In any case, I'll stick to looking for great business that have a moat and are there to reward shareholders for eternity. In life, you find what you focus on.

A final word, my analysis above doesn't mean that oil stocks cannot be the best performing asset class in 2020, they sure can as things change extremely quickly in the sector. It is just that I don't like to take the risk reward.

Housekeeping: Aviation sector coming next – low oil prices are a positive and stocks are down for various reason – Buffett owns them and it will be interesting if we can identify a moat – long-term tailwinds are a certainty.

10th TAKEAWAY: SUBSCRIBE FOR LOW RISK, FUNDAMENTALS BASED, HIGH REWARD INVESTING