Deep Value in Oil and Gas (aka Black Gold)

Investments that aren't reliant on a crisis to generate strong returns.

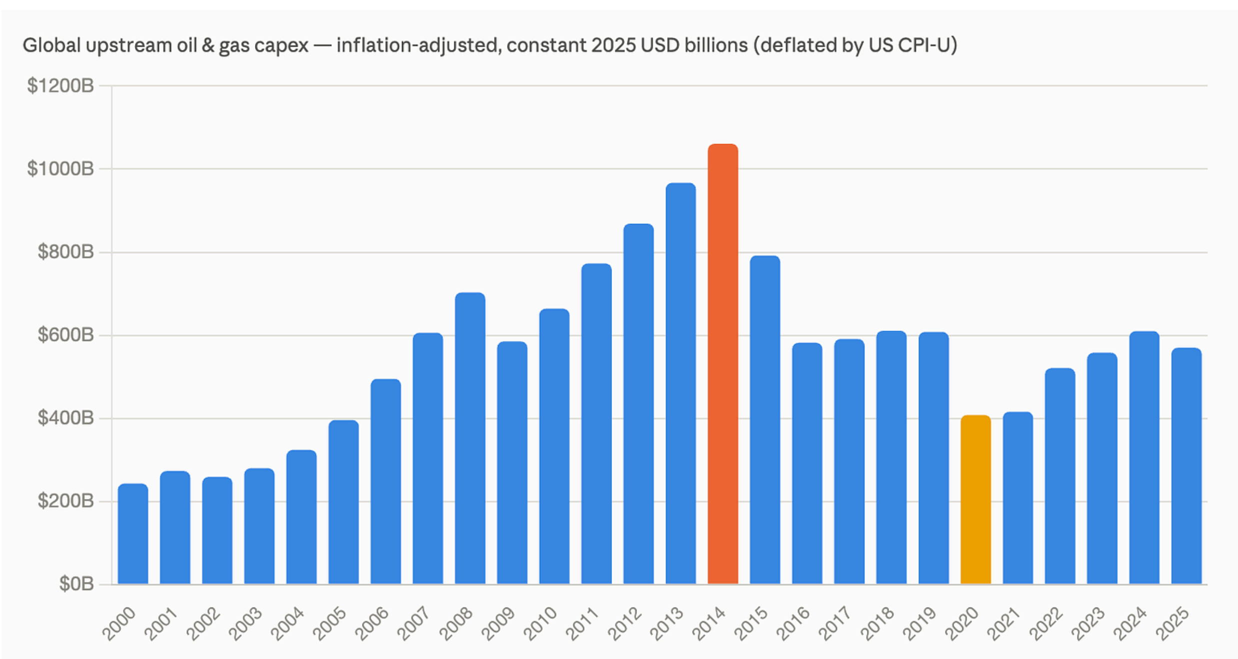
Here is a snapshot of the average **trailing** valuations for the four oil and gas producers we own. Very inexpensive, poised for growth and paying us over 15% in dividends.

EV/EBITDA	EV/OCF	Dividend Yield	Expected Production Growth (YE Run rate)
3.77x	4.68x	15.1%	+80%

Despite these incredible valuations - they are guiding to production growth of 80% from where they ended the previous year.

I'd take these investments even if I didn't think we were on the verge of an energy crisis.

Oil is a fundamental asset that has served as the backbone of energy production for hundreds of years. Today it accounts for ~30% of total global energy use. Despite this, investment in the sector has lagged over the past decade. Part of this can be attributed to technological advances that make drilling far more economical, but much of it is dictated because of the cycle downturn where past inadequate capital returns (ROIC) are linearly projected into the future as the basis why further investment is deemed unnecessary at the point when it is most needed.



Fast forward to the present and we face a supply disruption that imperils 20% of global supply. Roughly 20M barrels of oil a day flowed through Hormuz before the Iranian war began on February 28th. These were previously unencumbered flows that were not taxed, threatened or managed by any sovereign nation. That has now changed - despite the daily headlines, tragic loss of life and hundreds of billions spent, it's about all that has changed - with the power now resting with Iran and a US president who is spooked about any change in oil prices.

What hasn't changed is what one of those barrels costs. Shocking, right. Well, not if you dig below the surface. The primary factor that has kept prices largely in check are reserves. Some of these are commercial, some of these are government controlled. Despite the Western headlines, the largest draw on supply is currently happening in China. Thanks to a very shrewd decision to build up reserves into the conflict, China has been able to reduce a significant portion of their imports. Meanwhile, the US, developed Asia and EUR have been on their own reserve reduction spree to minimize the chances of an immediate energy shock.

The problem with all this is - it's temporary. Eventually the US can't draw on 1M barrels a day because the salt caverns reach a critically low level and pressure can't be magically injected to get the same throughput. Sure, the headline number might be 300M barrels stored, but the ability to draw gets increasingly weaker over time - reducing our ability to help cushion global needs. Especially important because of the refinery and export infrastructure we have domestically which has been a huge support to global energy markets.

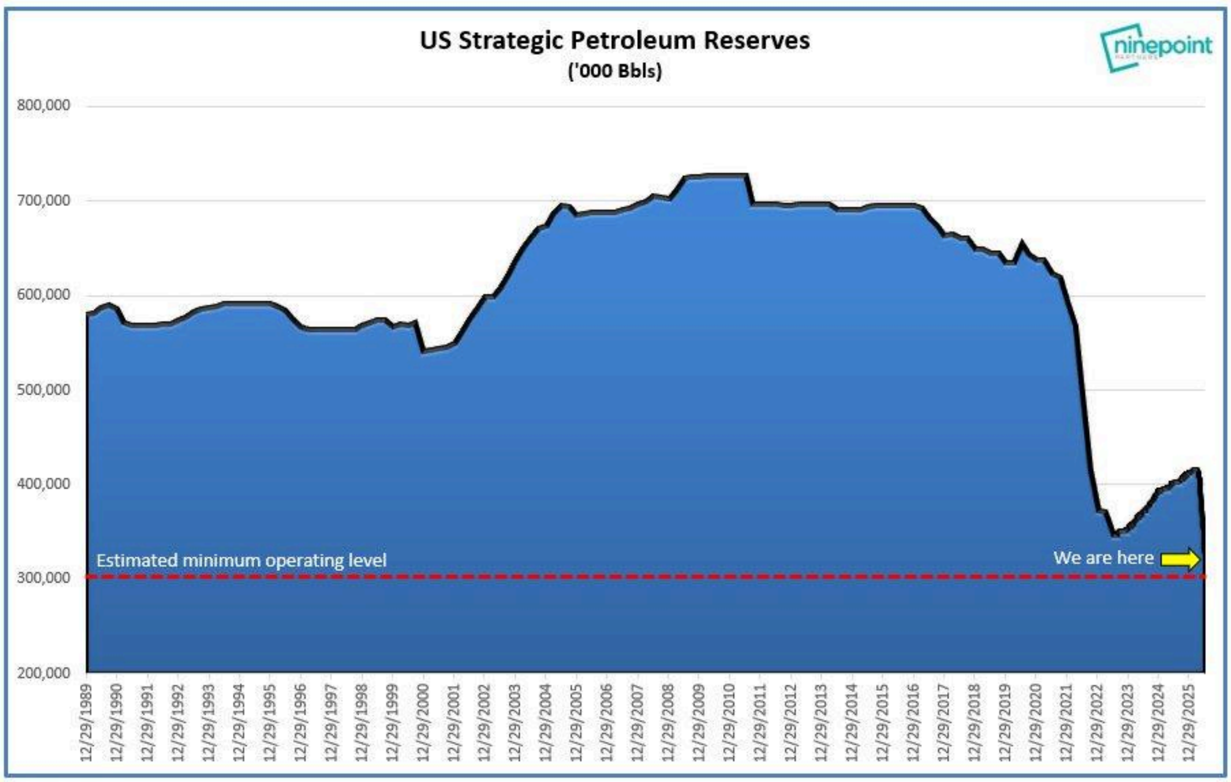
Hence, it seems to me everyone is sleepwalking into a potentially large and serious energy crisis.

What is the main counterbalance? Incentives. It inclines EVERYONE in the Middle East to figure out a workable solution because all their economies share one thing… they are largely dependent on the export of oil to prop up their petrostate economies. Iraq, Saudi, Bahrain, UAE, Kuwait, Qatar (more gas) and Iran all need the oil to flow to maintain some semblance of a workable economy. The problem is, it's very hard to predict the thinking of the IRGC… they are a hardline bunch that could spoil the whole drive to a rational end and who do not think according to western customs. This renders terms of a 'deal' or MoU (laughable really) that was disingenuously embraced by the puppets Iran uses as mouthpieces. The IRGC wants nothing short of Islamic domination with martyrdom awaiting those who are unable to see it through. That's going to be a tough group to forecast the actions of - especially now that they have their hands around the Strait (Bab el-Mandeb could be next). Will the hundreds of billions their Middle Eastern neighbors and the US are willing to give them directly or indirectly (e.g. via sanction relief, aka a complete capitulation) be enough for them? Hopefully.

To give a little context on this last (but critical) point. Let's say 10m barrels a day is the net disruption effect after you account for barrels that are going around (the Saudi East-West pipeline) or through the Strait. At $75 oil, that is $750M in lost revenue a day, or $275B a year. If Iran is able to extract a 5% royalty, they get $13.75B in income, which is 4-5% of its GDP and over double the government's tax revenue.

Furthermore, Saudi Arabia has historically protected their market share. For each day that goes by, countries are much more likely to push for energy development closer to home - making multi-billion dollar development projects much likelier to get the go ahead. This gives a huge boost to countries that have the untapped reserves - for example: Venezuela, Guyana, Namibia, PNG, Nigeria, Canada etc. It's in their economic interest to figure out a solution as quickly as possible.

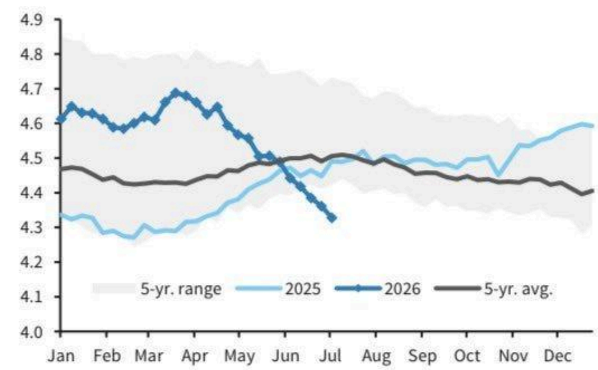
Here are a couple snapshots of the current state:



Source: DOE

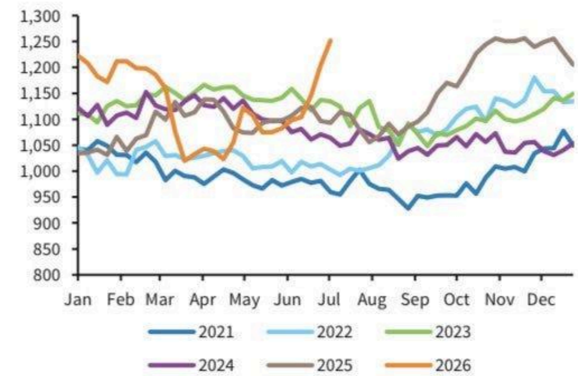
The global picture is much more important than the often shared US supply picture:

FIGURE 5. **Global total oil inventories have declined 450 mb since the war began**



Note: Barclays weekly global total oil inventory indicator, bb
Source: EIA, Kpler, Barclays Research

FIGURE 6. **Oil on ships in transit (mb) has surged recently**



Source: Kpler, Barclays Research

So in summary: we get more uncertainty with less of a reserve cushion and an emboldened enemy with lots of potential levers to pull (energy infrastructure, Red Sea via Yemen proxies, etc.). While I believe this is likely to be a transient situation that will correct itself because oil is an abundant resource, the mispricing in the near term is something that can be invested in that 1) acts as a hedge and 2) in an environment where some great companies can still be purchased at exceedingly cheap valuations.