Equity Research;Oil surge. Is it sustainable?

COLLINS SARRI STATHAM INVESTMENTS

Research Report

Report Date

17th September 2019

Analyst

Ravi Lockyer MSc Llb ASCI

Collins Sarri Statham Investments Ltd

Key Risks to Price Target

Not applicable

Please note the risk warnings and disclaimers on the last page of this document.

Drone strikes at Abqaiq- little data so far

The attack at the Abqaiq oil terminal and Khurais oil field leaves a great many questions unanswered. They could remain unanswered.

a) So where were the Saudi air defence systems? Saudi Arabia is the world third largest buyer of arms/ defence equipment (2018 budget $67.6bn). The Saudi military have been engaged in strikes against neighbouring Yemen since March 2015. But there appears to have been no security whatsoever in place for a drone attack.

b) Whilst Yemen's Houthi rebels have claimed responsibility for the attack there has been zero further comment. It is not the first time the Houthis have launched attacks on Saudi oil infrastructure, pipelines and processing plants. However this attack was very different to previous efforts, it was "surgical" (17/19 targets were hit) with a far more accomplished choice of targets hence the suggestions of military expertise/ Iranian involvement. "Smoking gun" evidence has not been forthcoming from either the debris or spy satellites as to involvement.

c) Iran has denied responsibility for the drone attack. The scale of the strike, we are informed the largest attack on Saudi soil since the Saddam Hussein incursion in 1990, appears out of all proportion to the normal Iranian modus operandi. It looks far too aggressive. We are not aware of Iran's religious leadership ever having started wars.

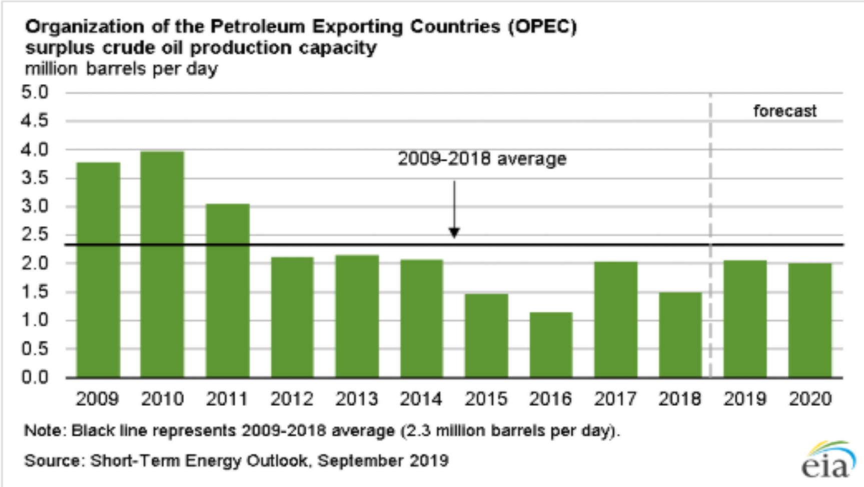
d) So far no precise launch location has been identified, and no military response. Even President Trump shied away from directly blaming Iran. The Trump tweet "we are waiting to hear from the Kingdom as to who they believe was the cause of this attack and under what terms we would proceed!" leaves the next step in suspended animation. We also suspect Trump's disinterest in Middle East military adventurism may be the main factor here.

The Saudi/ Yemen conflict, an ongoing armed conflict involving primarily air strikes/ military intervention has destroyed Yemen creating a refugee crisis and straining the Saudi economy. The Saudi leadership lacks a plan for bringing its military adventurism in the Yemen to a halt. Could this be a final step in the conflict?

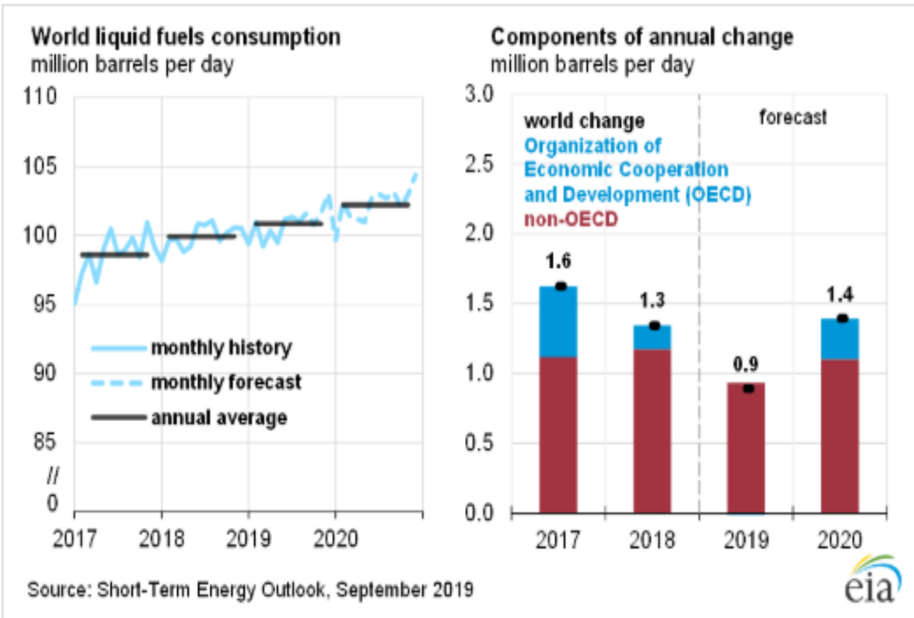
The lack of precise data is glaring, with only rough numbers of "5.7m barrels 'lost' per day" and 5% of global supplies based on the Saudi terminals' throughput. There may well be some disruptions to the local market.

However in terms of global oil market disruption, this is far harder to envisage. OPEC has 2m of surplus production capacity that can be tapped quickly. That is before the response from non-OPEC in particular Russia and the USA.

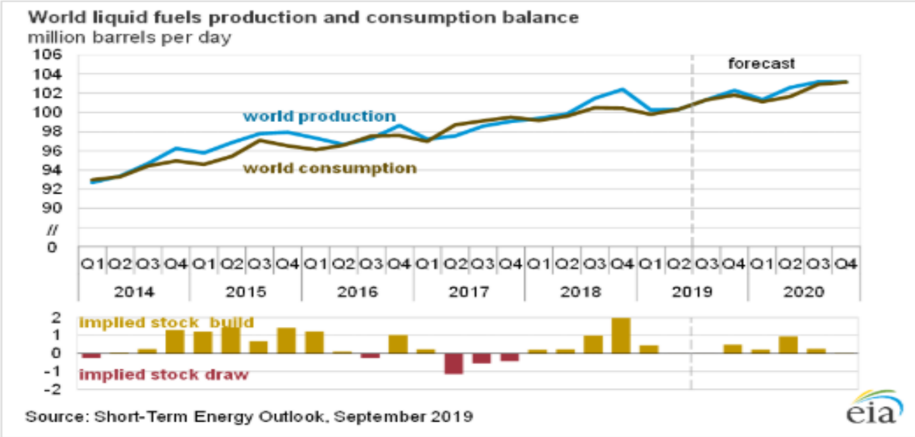
The US Administration response was quick. Trump authorised a release of the US Strategic Petroleum Reserve which would substantially ease US demand pressures for a sustained period. This disclosure dampened the speculative surge in oil prices and might explain the underperformance of WTI v Brent.



The 'circuit breakers' already available or employed could well cap further significant oil price gains. The oil demand picture at the moment, (below) annual oil demand growth of c. 1% is hardly the right context for a price surge based on fundamentals.



Indeed the current supply and demand picture looks balanced over 2019 and 2020 with very small additions to global oil inventories. Given the outlook oil prices may well stagnate over the next 12-18 months absent shock events.



The focus is again on Saudi leadership

Days after the unceremonious sacking of the experienced Saudi energy minister Khalid al-Falih, the drone strike is a significant new problem landing right in the lap of the Saudi royal family. By appointing his half-brother Prince Abdulaziz Bin Salman to the role of the energy minister, Crown Prince Mohammed Bin Salman (MBS) arguably lacks the expertise to handle this new problem. Chickens coming home to roost!

Al-Falih was also relieved of his role as chairman of Saudi Aramco for having reservations about the Aramco's IPO's merits, its corporate transparency and MBS insistence on obtaining a US$2trn IPO equity valuation. On that point it remains the case that investment institutions are also struggling to justify an Aramco IPO equity valuation of US$2trn. Whether the mooted IPO, which has been discussed off and on for c. 2.5 years will get to market is arguable.

The new leadership is likely to initially struggle to provide the sort of clarity that crisis management at this level requires. Recalling the Jamal Khasogghi murder and the numerous story changes that were peddled, one is left considering the extent to which Saudi OPEC market leadership might be at stake.

Importantly the Saudi leadership will either have to come up with a military/ economic response to this attack or stand back and play a waiting game/ covert war. Whilst we suspect the latter, this is a “known unknown” right now.

We view part of the oil price spike as reflecting increased Gulf tensions rather than any supply problem. We expect at least half the initial gains to be reversed with Brent settling down to its previous range of +/-5/10% from a $60 mid price.

Saudi recovery plan?

With 70% of Saudi government revenues/ 80% of exports dependent on oil, the Saudi leadership has talked for years about diversifying the economy. Achieving diversification is easier said than done, but the pressure is on. The American shale oil boom which has reduced US demand for OPEC oil has led to a drop in Saudi export earnings from $800m per day in April 2014 to c. $400m in June 2019.

The latest iteration of economic diversification "vision 2030" will require funding and on this point, the drone strike is a short-term problem that could derail Q3. Much depends on the speed at which the repairs get underway at Abqaib and the recovery/ defence plan going forward.

Frankly it is too early to say if the strike has any real lasting impact on revenues. Of greater import will be an early conclusion to the Yemeni armed conflict.

To conclude

Was I panicking in filling up the car last night? Or simply taking precautions. A bit of both maybe.

Looked at rationally, (I accept this is not always a rational world) I am hard pressed to see the oil price spike and anything other than a spike, i.e. one that is quickly reversed. I am not exiting my holdings of airline/ transport stocks just yet nor am I worried about the improving trend in global equities suddenly skidding on account of an oil slick of higher prices.

Collins Sarri Statham Investments Ltd. CityPoint Building, 1 Ropemaker Street, London EC2Y 9HT

T +44 (0)20 7153 1120 **W** www.css-investments.com **E** info@css-investments.com

SPECULATIVE TRADING IS NOT SUITABLE FOR ALL INVESTORS.

Collins Sarri Statham Investments Ltd. CityPoint Building, 1 Ropemaker Street, London EC2Y 9HT

T +44 (0)20 7153 1120 **W** www.css-investments.com **E** info@css-investments.com