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Buffett's Betting on Oil, and He's Rarely Wrong

By George Schultze
I wrote the book on vulture investing.

I've long been a believer that there's always opportunity in the energy field, if you know where to look for it. With his recent commitment of $10 BN to help Occidental acquire Anadarko, Warren Buffett appears to be of the same mind. And history has shown that many investors have done well by following the Oracle of Omaha's lead.

Much of the opportunity in that sector these days is related to hydraulic fracturing (fracking), which has turned the entire original paradigm for the oil business upside down. After bemoaning our reliance on foreign oil ever since the OPEC-induced shortages of the 1970s, the US' crude oil production now stands at record highs of ~12 MM barrels/day. Fracking has made it cheaper and easier to find oil in the US and turned this country into the world's largest producer. That's great news for our domestic economy, but it also pays geopolitical dividends by making us less dependent on imported oil from hot spots like the Middle East or Venezuela.

Although lower costs of extracting oil have made the sector much more attractive for new entrants, the resulting new supply shock has also caused all kinds of volatility in oil prices. Volatility can be a killer for upstart fracking companies with weak reserves and junk-rated debt funding. Such firms can easily find themselves facing a liquidity crisis and/or default as the price of oil drops. When that happens, stronger companies with cleaner balance sheets may be poised to pick through the wreckage and acquire new reserves in low-extraction-cost regions at attractive prices.

One of those regions is the Permian Basin, which was the major attraction in the Anadarko deal since it now produces more oil per day than the United Arab Emirates. In an interview with CNBC, Buffett described his investment as “a bet on oil prices over the long term” and “also a bet on the fact that the Permian Basin is what it’s cracked up to be.”

That’s a markedly different picture than what we saw in 2014-15, when crude oil prices dropped from ~$120/barrel to under $30. Back then, nimble distressed-securities specialists were able to short-sell numerous oil and gas exploration and production (E&P) firms which had taken on too much debt. As their cash flows ran dry, many of these E&P firms were forced into bankruptcy with their pre-petition shareholders substantially diluted or even wiped out.

The E&P space has really straightened itself out since then, with many firms that restructured emerging with much cleaner balance sheets and in a better competitive position. Energy XXI (ticker: EGC) was one such firm. This company had properties in the U.S. Gulf of Mexico waters and on the Gulf Coast onshore. It operated nine of the largest oil fields in the Gulf of Mexico Shelf, but was also heavily levered due to a junk-debt financed purchase of its EPL Oil & Gas subsidiary in 2014. Fortunately, Energy XXI was able to eliminate over $3.6 BN in debt in its reorganization, which later made it an attractive acquisition for privately held Cox Oil, a deal which closed last October.

Samson Resources is another example. After being purchased in 2007 for $7.2 BN, in what was then dubbed the largest ever oil and gas LBO, it was ultimately forced into Chapter 11 by 2015. With that, LBO-specialist KKR was forced to write down its entire $4.1 BN equity investment to $0 while the company’s billions of dollars in of junk-rated bonds and loans traded down to just pennies on the dollar. However, after Samson Resources emerged from reorganization, its outlook improved substantially. It eliminated over $4 BN in liabilities from its balance sheet and reduced over $300 MM per year in interest expense when it emerged as Samson Resources II, LLC in 2017. Since then, it has sold $1.4 BN in non-core assets and used the cash proceeds to pay its new shareholders $11.00 in special dividends. It also invested heavily in drilling new wells, which allowed the firm to ramp up production by 80% year-over-year. Today, privately owned Samson Resources II is on track to generate nearly $196 MM in EBITDA from production of over 11,500 barrels of oil equivalent per day. With those operating statistics and its attractive low-cost reserves, it’s become an excellent acquisition candidate for strategic acquirers interested in more rapid growth.

The super-major oil producers—Royal Dutch Shell, ExxonMobil, et al.—weren’t hit too badly when oil prices plummeted a few years ago. That was because of their healthy balance sheets and their diversification into more than just crude oil drilling (gasoline and other derivatives, refining, retailing, chemicals, etc.) Oil industry distress was much more prevalent among smaller E&P companies with highly concentrated revenue streams and excessive junk-rated debt. Their distress presented and continue to present numerous opportunities for acquisitions similar to the Occidental/Anadarko deal. Oil and other energy commodity prices will remain volatile going forward. This means there will continue to be numerous opportunities for distressed investors who understand the space and exercise prudence to generate profit.