Forbes

It May Be In Turmoil, But The Oil Business Isn't Going Away

By George Schultze
October 21, 2020

There's no disputing the fact that the Covid-19 pandemic has disrupted the global economy and forced numerous companies into distress. The largest bankruptcy filings since the onset of the pandemic run the gamut of industries—automotive (Hertz the largest bankruptcy filing this year with $24 billion+ in liabilities), telecom (Frontier Communications and Intelsat), retail (J.C. Penney, Neiman Marcus, and J. Crew), and restaurants (Chuck E. Cheese and Ruby Tuesday). But, ground zero for distressed companies remains the energy sector which accounts for seven of the 15 largest Chapter 11 filings this year—Chesapeake Energy ($11.8 billion in liabilities), McDermott International ($9.8 billion), Whiting Petroleum ($3.6 billion), Diamond Offshore Drilling ($2.6 billion), Extraction Oil & Gas ($2.2), Hornbeck Offshore Services ($1.5 billion), Unit Corporation ($1 billion)—with combined liabilities of more than $32 billion.

The oil & gas sector is a good example of what happens when an entire commodity industry goes through a restructuring cycle. Distress can be found throughout oil & gas. The companies affected range from upstream producers (exploration & production companies), to midstream companies (transportation by pipeline, rail, barge, oil tanker or truck, storage, and wholesale marketing), and all the way down to downstream companies (the refiners and the marketers closest to consumers).

The price of oil which fell to less than $19/barrel in April has rebounded since then to about $40/barrel, but that hasn't been enough to keep many companies out of bankruptcy. The playbook seems to be the same in most of these cases, where the company files for Chapter 11 and shareholders see all of their investment eliminated. In past situations like this, bondholders would at least get something but nowadays, for energy companies, recovery rates have dropped. Thus, the senior secured first lien lenders usually wind up getting the lion's share of the equity as energy firms emerge from bankruptcy. That looks to be the case with Chesapeake Energy which made its Chapter 11 filing in June.

That trend will likely continue but it raises the next question of how stocks issued by these restructured companies will trade after they fix their balance sheets and emerge on the other side.

Of course, valuation is important but good fundamental research, including an analysis of the types of investors who own the new stock, is critical for success. For instance, oftentimes a post-reorganization stock may not trade well until after the overhang of nonnatural equity owners (usually, former lenders) dissipates. Similarly, a top down analysis of the industry is important for success.

On that front, it's hard to predict exactly what the future will bring for the overall oil business. But one thing for certain is that the business is not going to go away, at least not in the short term. Currently, total world petroleum production is about ~94.5 million barrels/day while daily consumption is ~92.4 million barrels according to the US Energy Information Administration. The EIA also projects that 2021 production will rise to 98.8 million barrels/day which will not meet the expected consumption demand of over 99 million barrels/day. If true, these figures bode well for the future price of oil.

However, what if the global population succeeds at reducing oil usage? Even if, through conservation, efficiency measures and alternative energy sources, we managed to cut oil consumption in half (which would be truly extraordinary), that would still mean consumption of ~50 million barrels/day or over 18 billion barrels/year. That is still a tremendous amount of demand.

As part of the state of California's attempt to deal with the environmental consequences of society's dependence on fossil fuels, Governor Gavin Newsom recently signed an executive order that will require all new automobiles sold in the state to have zero emission by 2035. That sounds great on paper but isn't really all that impactful in the real world. That's because it's hard to say where we'll be in 15 years. It's a long time from now and certainly in terms of how rapidly technology has changed every industry over the years. Consider that the first Tesla vehicle wasn't unveiled to the public until 2006. The first iPhone didn't make its debut until a year after that and now you can't survive in the modern world without a smartphone. With this in mind, technological breakthroughs may change our desired energy policy dramatically even though the precise details remain unknown today.

In terms of that Californian initiative, besides technological breakthroughs which may force us to reassess our plans, we also have to remember that voters in the state will go to the polls four more times before 2035 and any new governor could even eliminate whatever regulations are in place. Thus, oil demand may remain robust for many years even if we commit to reduce consumption right now.

And when we talk about the future of the oil business, it's important to remember that oil is a crucial part of the industrial economy and is therefore used for many things besides just powering cars and trucks. For example, it's used to produce airplane fuel, petrochemicals, and even plastics which are used to manufacture many, many products. Oil is part of our global economy whether or not we like it and eliminating its use entirely may therefore never happen.

And while it's hard to predict whether the price of oil will be higher or lower in the future, there is no doubt that it's a finite resource which depletes with each barrel of oil pumped out of the ground.

As companies invest less in an industry due to its distress, eventually that underinvestment sows the seeds for the next boom in that very same industry. Right now, energy is the most distressed industry

out there. In fact, it doesn't look like anyone is going to great lengths to invest major new capital into drilling for new reserves since the outlook is so bleak. On balance, right now people in the industry are just licking their wounds and trying to figure out where the next knife may fall.

Following a period of distress like that, it is highly likely that supply will decline as we've seen with most other distressed industries over the years. Even if demand declines by a lot, I'm thinking 30, 40 or even 50% over the next few years, who knows how supply might evolve. The combination of reduced investment and naturally depleting reserves together may go a long way towards reducing supply sufficiently so that pricing in this market remains balanced.

Having said that, it's hard to predict exactly where the price of oil may go. But, as we see with virtually all commodity industries, the lowest cost operators will do best while those with overleveraged balance sheets will do worst. You can't really compete on anything but price in a commodity industry so managing costs is paramount.

For investors who understand the energy industry, there are some great opportunities for investment today. When an entire industry becomes distressed, it makes sense to step back and assess whether the whole thing should be written off as irrecoverable (think travel agents after Travelocity, Orbitz, et al.) or whether it's just undergoing a more gradual change where you can still make money by buying something for the right price. Some firms that recently emerged from restructuring in energy industry are cheap enough that there's a good risk/reward trade off in buying them now since they have steady operations, newly repaired balance sheets, and will likely continue to generate decent profits for many years.