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Insights Series | Energy

Podcast Transcript

Host (intro):
From Boston Partners, welcome to Insights, in depth conversations with our investment team on investing across geographies, sectors, and industries – beyond what you read in the headlines.

Paul D. Heathwood, CFA **Director of Investor Relations:**	Good afternoon and welcome to Boston Partners Insights. This is our 17th installment of a series of interviews that we began four years ago. Then as now, the purpose of the interviews is to provide deeper insight into the capital markets, by going beyond the headlines and providing a deeper look into a sector and industry from the perspective of a fundamental research analyst. Our goal is to provide additional information in context that we hope will allow you to have more meaningful conversations with your clients and colleagues. Today, we return to our beginning four years ago to discuss Energy. Now, in preparation for the call today, I took a look at the price of oil when we first did the call in March of 2017, and that month oil hit $53 a barrel. I took a look at the price of oil today and oil is at $58 a barrel. So using the price of oil as a gauge, it seems to indicate that not much has changed in the energy markets over the last four years. Well, certainly that is not the case. A year ago, the price of oil plunged to $17 a barrel as the energy markets were hit with a double whammy of a global price war driven by oversupply, as well as complete demand destruction through the onset of the pandemic and the resulting economic shutdown. The entire energy industry was turned upside down. However, things have begun to recover a bit and in fact, changes in fundamental conditions within the sector and a near complete turnover of the underlying investor base makes energy an interesting idea from an investment perspective. To help us unpack all of this, we are joined by fundamental research analyst, Aaron DeCoste. Aaron covers the energy markets for Boston Partners and his job is to make a fundamental assessment on a company-by-company basis of the sector, industries, and ultimately to make recommendations on how Boston Partners portfolio managers should allocate assets in the energy sector.
Aaron DeCoste **Equity Analyst:**	So certainly, a lot has changed in the past 12 months, even going to just pre-pandemic, which really started, I suppose, mid March of last year, the beginning of March was an OPEC (Organization of the Petroleum Exporting Countries) meeting where we saw the first steep decline in oil prices where Saudi Arabia and Russia could not agree on production cuts that led to the Saudis actually flooding the market with oil. That was the first drop we saw on oil prices. Subsequent to that two weeks later, you saw the COVID-19 lockdowns really begin in earnest. That's where you started to see the demand destruction. That's where you saw oil plummeting, energy prices, energy stocks, all falling pretty significantly. That's actually where you saw oil at one point, the futures contract go below zero for the first time in history. So certainly things have changed since then. Fast forward to this year oil prices have actually gone into the mid $60 range. I think a lot of people thought that probably wasn't going to happen again.

Paul Heathwood:	If you go back 12 months ago, what were some of the data sets you were looking at? I mean, I guess you could intuitively know that there was going to be trouble, but you got to do a little bit more work than that. You just can't base on your intuition. What are some of the data sets you were looking at, take us back to that time and what your thought process was and how you make it through such a challenging period.
Aaron DeCoste:	So, if you go back again, this goes back to just before the pandemic, we had noticed probably starting in middle of 2018, that global demand for oil and gas, oil products, gasoline, diesel was starting to slow a little bit. That decelerated for really two years, supply was ample and a lot of that was coming from the US. I think everybody understands that, as you got into 2020, you still have those issues in the early part of the year. So as a firm, we had to be cautious for energy, for several years. You get to the OPEC meeting, additional suppliers to markets are an issue. As you got into the COVID-19 lockdowns, obviously the dynamic had changed you really had to focus on demand and what you didn't have in previous years and things we started to look at where you could actually look at congestion data. So, what we started looking at early was congestion data in cities China like Wuhan, Hong Kong, Shanghai to see what traffic was like. And so we look at sites like TomTom and then what we were able to do is start looking across the world and seeing how that was spreading and impacting. So we were able to make assessments of really how much demand restructuring there was going to be. On top of that, the TSA (transportation security administration) also publish this data and flight data you can find to understand what does jet traffic look like, and you could see that precipitously falling too. So pretty early on, we started to look at this and to really tell the demand was going to be a real issue. I would say probably in mid March is where we picked up on it and you saw a pretty steep declines all the way into April.
Paul Heathwood:	So maybe we could fast forward to today. And how do you look at supply right now? You mentioned that you've had a lot of consolidation and some supply has come out. Maybe you can put some numbers behind that and give us a sense of where they're going.
Aaron DeCoste:	Yeah. So on the supply side, really the key was OPEC obviously taking barrels off the market to balance it, but really the focus I think, is to focus on North America which had been the concern that had been the growth in the market for the better part of the decade, from peak to trough of where you're kind of producing now is about 2 million barrels a day a decline from the peak of last year. Now, unlike OPEC the US., can't just bring that production back on without significant increase in CapEx and which I talked about before, likely isn't going to happen without companies spending and will take years to get back to you. So right there, you get 2 million barrels a day offline on the supply side. OPEC likely if you look back over the past 20 years, not a ton of growth there, there's a bit Europe's been declining. They're not going to grow. And you've heard from BP and Shell, they're not interested in investing in oil anymore they want to shift to renewables. So you really have a lack of oil production growth globally and the low price prices really shocked companies into cutting CapEx. So the supply going forward, we expect to be significantly constraint.
Paul Heathwood:	Interesting. And how about demand? Do you see that coming back as the world tries to emerge from the pandemic and the economies try to grow again?

Aaron DeCoste:	Yeah. So demands is the wild card. But if you look back, going back to 1980, demand has generally been pretty resilient. Eventually, there is an expectation that demand will start to round out as we go into renewables, as emerging market economies like China, India fully develop and there's less growth there, but we believe demand will go back to the pre pandemic levels and continue on a growth trajectory. Obviously, as we get longer down the decades, that will slow down a bit. The question will be is how fast do we get back to that number? And there's been some indications for instance, gasoline demand in Europe, in September and October was actually up year over year before another set of lockdown. So you are seeing some trends of more people driving, less public transportation, and then obviously jet fuel has been down. But if you look back to the early two thousands that bounced back, it took about two to three years, but it does eventually come back.
Paul Heathwood:	Excellent. Let's stick on demand for a moment. Let's talk a little bit more about the longer term picture. Certainly you read in the press and know climate change is a big issue that people are globally trying to deal with. And the reduction of fossil fuel use is at the front end of doing all that. So I believe that the demand for fossil fuels is going away, whether it be through electric vehicles or other means, what is the longer-term demand picture look like and how does that going to play itself out in the period ahead?
Aaron DeCoste:	Yeah. So in the near to maybe medium term, you will still see the same demand growth trajectory that you've seen in the past. And I'll discuss that in a second. As you get further on the decade you will certainly see some deterioration like I said before, with emerging economies needing less gasoline, diesel as they develop. The one thing to keep in mind is most people look at oil demand and think gasoline, diesel. So really, if you broke down the oil market, a hundred million barrels a day, you have to break it down and understand how could you displace those barrels? So gasoline is about 25% of the market, and that's what everyone thinks about what you can displace with EVs. So in the long run, yes EVs will display some of that capacity, but that's 25% of the market and it will take some time to get there. About 30% to 40% of it is diesel. So you're thinking trucking, marine shipping of that nature, a little more difficult to displace. Obviously, Tesla's got a ADV truck, but that's probably a longer term displacement issue. Then you get into jet fuel, which is roughly 10% to 15% of the market. That's going to be very difficult to displace as one can imagine, but there are companies looking at it. And then the last percentage, which is about 25% is petrochemicals. Those are very difficult to replace and if you understand, they are really the building blocks for everything around us. An Under Armour shirt on a golf course is petrochemical, the dashboard in your car, your chair, your backpack, this is all petrochemicals. So that's really hard to displace. So if you look at the big picture of what's in that hundred million barrels a day, certainly gasoline will be disrupted and you're already seeing some of that. But the broader picture is it's very difficult to disrupt a lot of that, particularly when you think about developing economies, again like China and India, there is a, I would say, a home bias for US and a European investors to think, well, oil demand is not growing it's well, because the growth is in these other emerging economies. And when they do develop in 20 or 30 years and are more on par with North America and Europe, the growth will be stagnant at that point.
Paul Heathwood:	So a realistic expectation on a drop in demand is going to be playing itself out over decades. And it's maybe reducing things rather than eliminating them as you hear some parties say.

Aaron DeCoste:	That's generally what I think is going to be.
Paul Heathwood:	Interesting. One of the things that you talked about was that energy was viewed as a growth area, five, six, seven years ago, and you had a lot of growth oriented investors, and then you had the initial decline in the middle part of the 2010s, and you almost had a complete recycling and turnover of the investor base, and now a lot of value oriented investors, energy shares. How does that have an impact on the companies? Do the companies change how they operate? How do you see that influencing the future for energy stocks?
Aaron DeCoste:	Yeah, I think that has a pretty big impact. You've seen a pretty big turnover investor base a lot of investors have turned away from energy, either from poor investments or capital allocation decisions from the company, or grow with like tech has worked and you've seen the shifts. So from a value investor standpoint, it's certainly gotten more attractive. Investors are still skeptical of the capital discipline and as I mentioned before, if you think about shale and one of the things I like to point out is, and not to pick on a company in particular, but it's a very good example when they haven't done M&A for the past 20 years. So it's a very clean example, is Pioneer Natural Resources. If you looked at a chart going from 2019 back to 2000, they generated positive free cashflow once in 20 years in 2006. And going forward, there's going to be significant free cash flow, which you saw pre 2019 as well we want to grow double digits, we think that's the best way to generate shareholder return. Going forward, the investor base, after many years of seeing country CapEx, returned cash to shareholders we want dividends, companies weren't doing that. You've now seen dividends across a lot of the E&Ps and a commitment to only grow mid single digits and return the rest of the cash to shareholders. So that's really a divergence. There's still a lot of skepticism in the market, but if there is a dividend yield out there for these companies that they have to hit, it's also going to restrict how much growth capital they can put to work. So it's going to be interesting to see if these companies really do hold their discipline.
Paul Heathwood:	So that's going to be a big factor you're going to be assessing in the companies that you invest in, is management's discipline of returning capital, having some restraint in terms of developing new production, that could potentially lead to better returns and cashflow generation and compounding returns for energy investors going forward. So that could be a see change that could make the sector somewhat interesting in the period ahead.
Aaron DeCoste:	Well, both from a capital return standpoint to investors, but also from a supply standpoint. So you won't see that supply hitting the market, which would support oil prices.
Paul Heathwood:	Wonderful. Let's shift the conversation a little bit to the political agenda, and obviously you have a new administration in, and they've talked about doing things to curb the use of fossil fuels. How do you see the Biden administration impacting the energy space and what does that mean for energy stocks?

Aaron DeCoste:	So from that perspective, I think the headlines have been a little bit, probably worse than the reality. Obviously they wanted to put a ban on new leases. Most of the federal lands have been leased anyway, they haven't put drilling permit restrictions out yet. So as of right now, it certainly isn't impacting as much as I think there was expectations, but there is that constant overhang in the market that the administration will start to put restrictions on federal lands, potentially change taxes for companies. So they wouldn't be able to depreciate a third of their investments up front, which returned a lot of these entities into immediate taxpayers. So that's kind of a shifting guideline. One of the more interesting things is going to be probably, we've looked at as kind of an impact on our food chain as it were. So a big push is for renewable diesel. They want to blend diesel and display some of the diesel to make renewable diesel. And the feedstock for renewable diesel in general or renewable gasoline is either corn to make ethanol or soybean to make soybean oil. So what's happening, where are you seeing is soybean prices are starting to be pushed up because of the pull from these renewable diesel plants and the government's incentivizing by both giving a tax credit plus providing renewable credits to the firms that are generating this fuel. And so what it's done is it's pushed it up. And if you think of soybeans, soybeans are crushed to convert soy meal, or soy oil. Soy oil goes to the renewable diesel plants or to food think salad dressing. The soy meal goes to meat and poultry companies to support their feed. So from that perspective, right now, the US is net export of soybean oil. We expect within a year or two, that we're going to be a net importer, likely from Argentina or Brazil. And we're going to be significantly short in soybean oil, which is going to push prices up for this and for renewable diesel. So all in all, it looks like there could be both an impact from fuel prices with oil, but also from food prices. And it's a bit of an irony that our energy policy is going to start creeping into our food prices.
Paul Heathwood:	Wow, that's quite interesting. One thing we haven't talked about is natural gas seen as a more cleaner means of energy production, something that there's a lot of supply in the United States. How do you see fitting into the mix and what are your thoughts there?
Aaron DeCoste:	In terms of energy transition, I certainly think natural gas is important. It is cleaner obviously than oil, maybe on par with nuclear, maybe a little bit less given some of the waste issues with nuclear, but I think it's certainly an important piece of the puzzle. And as you've seen in Texas, the shift to wind did create an issue. And one of the issues was all of that wind was pushing natural gas and coal plants into retirement. So when an issue did arise, where there was a significant need for power, there wasn't enough assets to back up the intermittent wind power or solar power. So it is going to be definitely needed. In terms of pricing there's still a significant amount of natural gas in the US, with very cheap prices. So I wouldn't expect to see any appreciation above probably $3 for, in the next five to 10 years. Plus on the oil side, you're still getting a pretty significant amount of associated gas. For a lot of the oil producers, oil prices go up gas is just a by-product that they can bring out of the ground. So I certainly think it is needed for the transition, but from an investment standpoint, investing in the natural gas companies is I think from a fundamental standpoint, it's a little bit challenging right now.
Paul Heathwood:	Good. So you've really painted an interesting picture of energy now versus a year ago and versus four years ago. Are there any companies or industries within energy that you find interesting now as a result of all that's going on, that hadn't been interesting previously that you can talk on company or industry specific?

Aaron DeCoste:	Yeah, so just, within the industry sleeves in particular, the oil field services. So oil field services, by and large were pretty choppy momentum. The price of the stocks really range traded you saw a lot of capacity coming into the market. There was a lot of competition you saw pricing deflation for the past four or five years and valuations just weren't attractive. And I think part of that too, was as you look at consensus numbers, and if you go back several years, consensus numbers from analysts always had these hockey stick, like returns on EBITDA, or EBITDAs here, but it would be up significantly the next two years. And that's how you justify a higher price and higher multiple. And it likely wasn't going to materialize. When COVID-19 finally hit, you saw all of these consensus numbers get readjusted down. As we looked out in August or September, most consensus numbers for the Halliburtons, the Schlumbergers were on par with 2020 and 21 and 22 and not much up at 23. And if you look historically, that just didn't make sense to us. And the stocks were more than reflecting what those prices were. So definitely a shift there and what we've done is shifted more into the oil field services and certainly into the upstream side as well. That was another key is it's fundamental it's improved significantly in the upstream side we saw a, more of a shift to wanting to own some of these companies still staying in a higher quality, still staying at companies that were committed to, capital discipline, returning cash to shareholders, but the fundamentals and valuations of both these sectors, again became the most attractive I've seen again in the last probably 20 years.
Paul Heathwood:	Interesting. And that's what I wanted to finish up with. Perhaps maybe you could just summarize your thesis on energy and investing in energy companies, putting some historical context of is now an interesting time. Do you think it has some room to run? And what are the things you're going to be looking at as signals to see whether it's going in the direction or things have changed and maybe it's time to take some profits and then move on to other things.
Aaron DeCoste:	Yeah. I certainly think there is plenty of room to run from here, but again, it's cautious optimism. One of the things I'll be looking at certainly is going to be the demand trajectory. As I mentioned before, I think it's going to continue to improve for the reasons I mentioned. And then on the supply side, really the supply is going to be focusing on discipline in the US. Are these companies and the consolidation is that limiting growth in the US? Understanding that there will be no growth in Europe, OPEC likely won't grow, Asia is probably not going to grow and Latin America you'll get a bit of growth. So those will really be the key things to focus on. So it's going to be one of those things where we monitor quarterly to say, is that thesis still playing out, is demand improving, and is supply still restrained and as long as that continues, it'll still be attractive provided that the fundamentals and the valuation are still within a reasonable range, which they continue to be. But what you will see is you will see momentum start to improve, and you've started to see that kind of an earnest across the sector.
Paul Heathwood:	Wonderful. Well, Aaron we appreciate you speaking with us today. Very insightful and some exciting things going on in the industry sector. So thank you again. And we look forward to speaking to everybody in our next installment. Thank you for tuning in.
Aaron DeCoste:	Thanks for having me.

Paul D. Heathwood, CFA
Director of Investor Relations

Mr. Heathwood is the Director of Investor Relations for Boston Partners. In this role, he oversees the firms portfolio research efforts and distribution efforts in North America. He has held a number of other roles at the firm, including product manager for alternative investments, intermediary sales, institutional sales, client service, and consultant relations. Previous to his sales and client responsibilities, Mr. Heathwood spent five years on the investment team as an equity trader. He was also a founding partner of Boston Partners Asset Management, upon its inception in 1995. Mr. Heathwood began his investment career in 1993 as an equity trader with The Boston Company Asset Management, Inc. Mr. Heathwood holds a B.A. degree in economics from the University of Colorado at Boulder, and holds the Chartered Financial Analyst® designation. He has twenty-eight years of industry experience.

Aaron DeCoste
Equity Analyst

Mr. DeCoste is an equity analyst with Boston Partners specializing in the energy, engineering & construction, and metal & mining sectors of the equity market. He joined the firm from Loomis Sayles where he was an equity analyst covering the energy and materials sectors. Prior to that, Mr. DeCoste was a senior director at Devonshire Investors, Fidelity Investments private equity investment arm, focusing on energy, transportation, construction and fintech investments. He began his career in audit at KPMG. Mr. DeCoste holds a B.S. degree in finance with a minor in mathematics from the Bentley University and an M.B.A. and M.S. finance degree from Boston College. He has sixteen years of investment experience.

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