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The Australian Energy Sector – A Premature Rush for the Exit?

Our weekly view on Australian equities.

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The Long and Winding Path to Net Zero

There is no doubting the importance of the global energy transition as the world moves toward its net zero 2050 target. However, recent events in respect of both renewable and legacy energy supply disruptions across the globe have driven sharp rises in oil, gas and coal prices. This has highlighted that the path to net zero will be a long and winding one.

While the very long-term outlook for fossil fuel demand appears bleak, we still appear to be some way from peak oil demand, while the (in our view unavoidable) role of gas as a transition fuel suggests demand is likely to accelerate in coming years, before plateauing and ultimately declining much further down the track.

These sticky demand patterns are playing out against a backdrop of very limited capital expenditure needed to deliver new supply to replace the inherent yearly decay in global production capacity.

Solid medium-term demand with limited supply has for some time seemed to us as a very bullish setup for the Australian oil and gas sector for the next few years.

Energy Sustainability Pivot has Weighed on the Australian Energy Sector

The Australian energy sector outperformed the global energy index over the past 5 years, however, post-COVID this has reversed, with Australian energy underperforming global peers by more than 10% since March 2020.

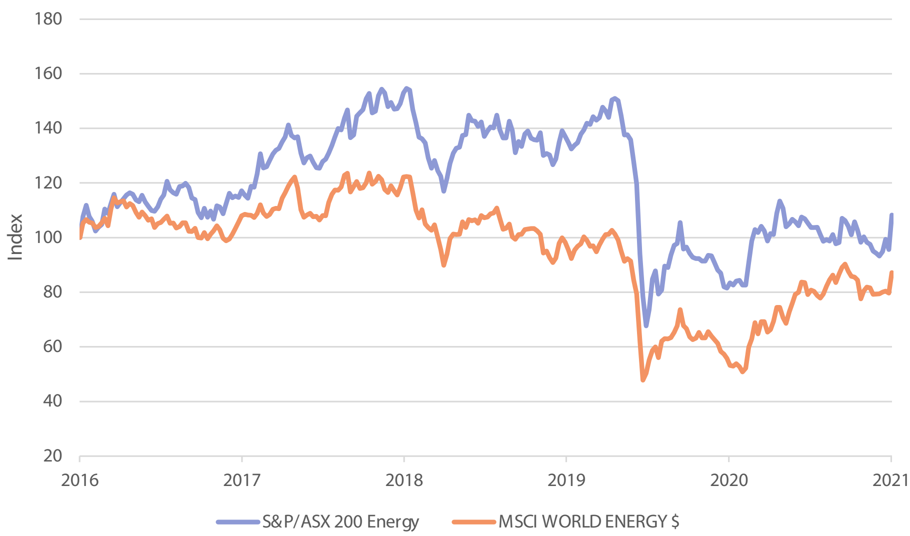
Global energy stocks reacted earlier to the emergence of the sustainability theme, which started to gather momentum in 2017-2019. In contrast, the ASX listed energy stocks have seemingly only seen the impact of shifting domestic institutional sustainability preferences over the past year or so.

Global energy stocks themselves have been somewhat reluctant to push ahead over the past year despite a rising oil price. However, the most recent bout of strength in energy prices over recent weeks is starting to see interest return to the sector.

In the case of the Australian energy sector the sustainability discount becomes quite stark when we look at equity prices relative to Brent oil (see Exhibit 2).

Despite companies having inherent operating leverage to the oil price, all three large cap energy stocks have underperformed oil as COVID reopening has seen the oil price surge. Even STO, with the ability to x2 its production from 2019-2024, has not kept pace with oil. We believe sustainability issues have hampered relative performance – more so in this cycle than in prior oil and gas upcycles.

Exhibit 1: Australian energy sector has underperformed global energy post-March 2020



Source: Refinitiv, Wilsons.

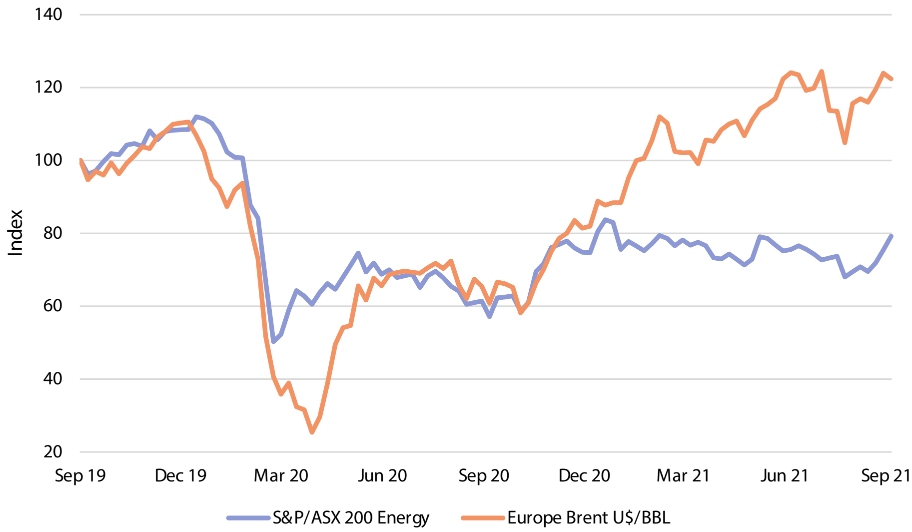
Both Oil Search (OSH) and Woodside Petroleum (WPL) have both had environmental and governance (resulting in a high degree of management turnover) issues working against them in recent years.

Are Equity Valuations Now Permanently Impaired?

This is the big question the sustainability theme raises. While sustainability discounts may now be permanent, because businesses with potentially stranded assets will at some point experience slower growth, there are two critical points that could potentially re-rate equity valuations:

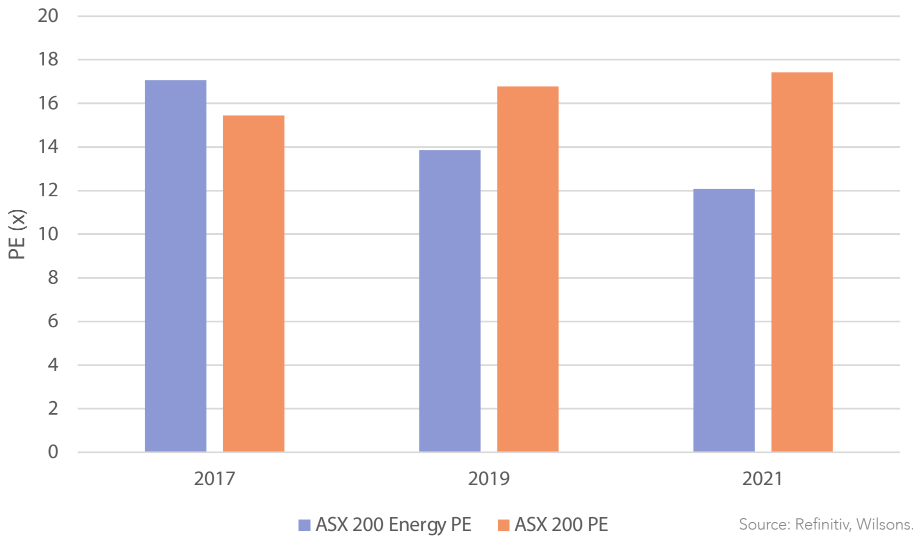
1. **A commodity squeeze –** Coal, oil and gas markets through 2021 have tightened considerably as supply fails to meet demand – pushing prices to cycle highs. This is despite the prevailing view these commodities are in terminal decline. Equity prices of producers have started to rally in response as the market begins to focus on the potential for higher than expected cashflow generation – closing in part sustainability discounts. However, while share prices are now starting to lift, valuations still look cheap in our view. Even if multiples stay compressed the potential for strong near-term earnings/cash flow growth based on strong commodity prices is likely to buoy the sector.
2. **M&A** – Stranded assets can still generate very strong cash flows and returns until the end of life – even if the growth rates ultimately do plateau and subsequently decline. While this may be unappealing for the public market, alternative groups of investors may see this as appealing.

Exhibit 2: Australian energy sector has not kept up with the oil price over the past 12 months



Source: Refinitiv, Wilsons.

Exhibit 3: PE based 'sustainability discount' has emerged in the Australian energy sector



Source: Refinitiv, Wilsons.

Focus List Energy Sector Positioning (Overweight)

We believe oil and gas prices are vulnerable to a potential commodity price squeeze over the next few years despite our reservations around the very long-term (multi-decade) growth profile. The potential for oil (and particularly gas) demand to be higher than pre-COVID levels, matched with a multi-year period of exploration under-investment, suggests oil prices could once again challenge +US$100/bbl in this cycle and stay well above current consensus long-term pricing for a number of years. The Wilsons Australian Equity Focus List is overweight energy for this reason. The relatively subdued price action of energy stocks so far suggests a significant opportunity exists.

Santos (STO) remains our preferred exposure in the energy sector. Post the merger with Oil Search (OSH), STO will have greater scale to self-fund growth initiatives which could see oil production double between 2019-2024. This would place STO within the top quartile of global oil & gas producers by production growth over the period.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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