Australian Energy Sector: Streamline to Rerate

Our weekly view on Australian equities.

09 February 2022

The Opportunity for the Australian Energy Sector

We believe the Australian energy sector could rerate if it moved to slow its production growth outlook.

Despite a rising oil price environment, where positive operational leverage should be highly advantageous for company earnings and share prices, the performance of Australian energy stocks has been disappointing. Over the past two years, Brent oil is up +70%. Santos (STO) is -5% and Woodside (WPL) -14% on total return basis (Feb 20 vs Feb 22). Over this period, Australian energy company share prices have lagged offshore peers by over 50%.

We see an opportunity for the Australian energy sector to cut its production growth and return a higher level of free-cash-flow (FCF) to shareholders. If the sector adopted a capital allocation strategy more akin to what the global oil majors have done, we believe the Australian energy sector could see a significant rerating.

In our view, investors are increasingly prioritising cash returns over long-dated production growth. This is particularly in those sectors like oil where the long-term demand outlook, and therefore the return on equity capital, could be challenged by a move to lower carbon intensity energy sources.

With earning results from STO and WPL still ahead of us, we see an opportunity for Wilsons Australian Focus List member STO to revise its capital management framework.

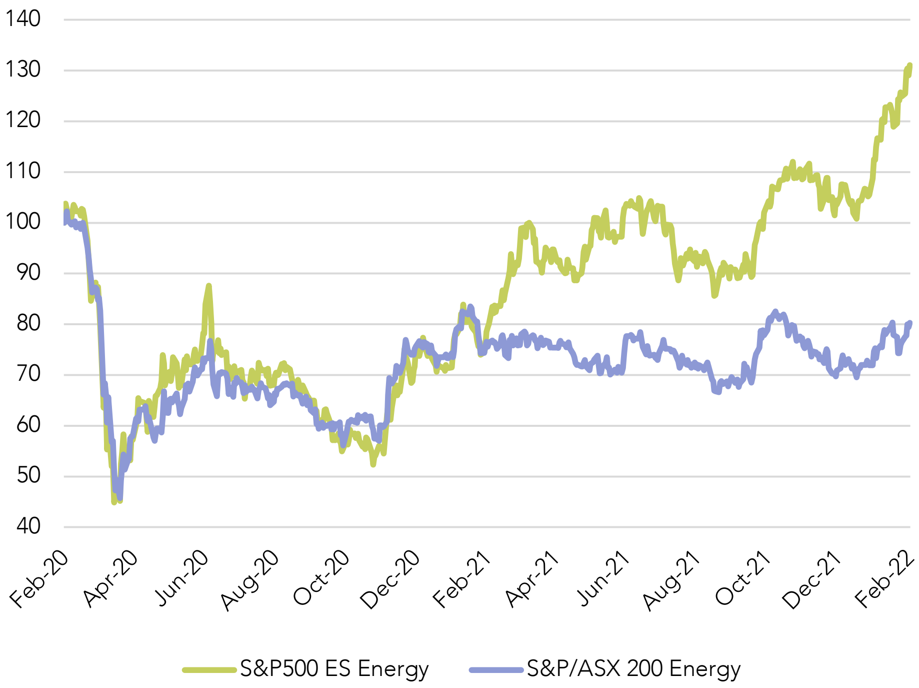
At spot energy prices, with a revised payout ratio from 30% to 50%, STO dividend yield would lift from 3% to 5.5-6.0%. Global energy giant Shell last week took steps to increase shareholder returns, similar to what we believe STO needs to do. We think the timing is right for Santos to streamline and revise its capital management policy.

Australian Energy Sector Performance

The +45% underperformance of the Australian energy sector vs the US energy sector over the past two years can be explained by key three influences:

1. Production growth not being valued by the market
2. Lack of near-term (cash) returns
3. The increased perception/risk of stranded asset concerns

Exhibit 1: Australian energy has underperformed US energy by >45% over the past 12 months



Source: Refinitiv, Wilsons.

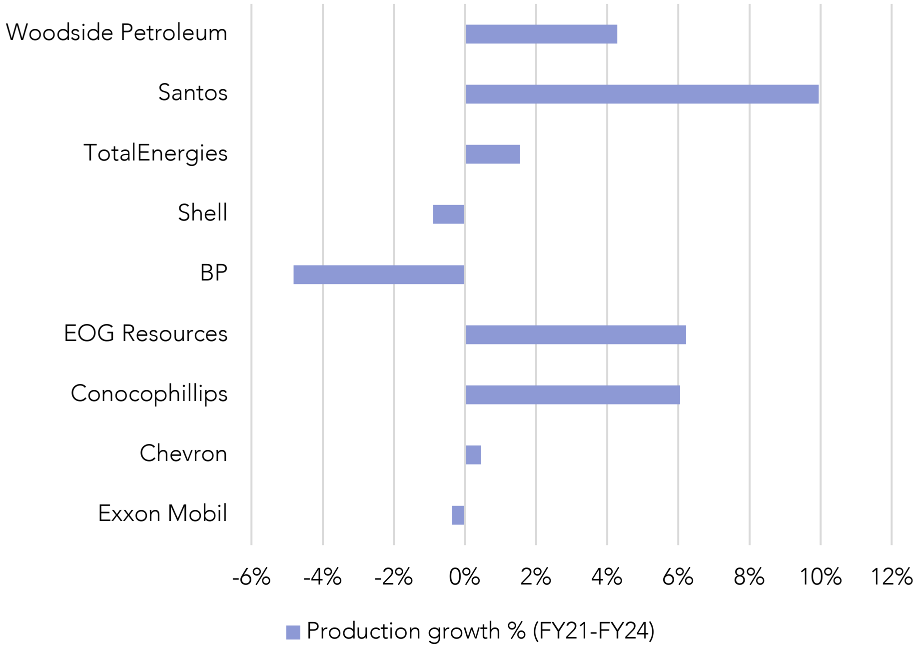
Undervalued Production Growth

Australian energy producers have historically pursued a pro-growth agenda. This was premised on growing domestic demand, but more importantly, our proximity to Asian growth markets. The attraction of selling to Asian customers has underwritten many expansion plans across the sector.

In recent years, STO has pursued a pro-growth strategy with sanctioned growth projects in Australia and Papua New Guinea (PNG). WPL's growth agenda has been more muted as the company elevates several growth projects that could materially lift production over the long-term if approved. In recent years, STO has pursued a pro-growth strategy with sanctioned growth projects in Australia and PNG. WPL's growth agenda has been more muted as the company elevates several growth projects that could materially lift production over the long-term if approved.

Despite STO's much higher growth, the relative performance of STO and WPL has been remarkedly similar over the past two years. For all the excitement over STO growth plans, the market is unwilling to reward STO with a higher share price. It would seem to us that the market is heavily discounting growth, even short-medium-term production growth.

Exhibit 2: Australian energy has higher forecast production growth vs offshore oil majors



Source: Refinitiv, Wilsons. Forecast production growth 2021-2024

Exhibit 3: Despite STO's much higher production growth the share price has not materially outperformed peer WPL

Source: Refinitiv, Wilsons.

Cash Returns Lacking

Production growth can be funded in three ways; internal cash flows, external capital inflows (debt and equity), or asset sales. There are trade-offs with all three funding sources that need to be considered.

Whilst internally funded growth projects are typically seen as the preferred funding mechanism, the near-term cost of this method is a lower FCF and dividend yield. Relative to both US and European companies, STO has a noticeably lower FCF yield, dividend yield, and dividend payout ratio as cash is needed to support growth.

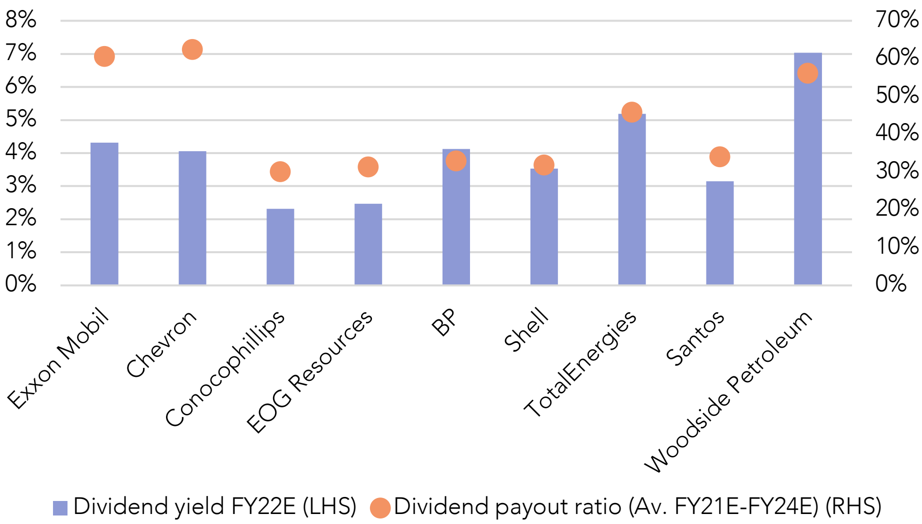
We believe investors are become more demanding in how energy companies allocate capital and are less willing to back longer dated expansion projects. In our view, the preference for near-term cash returns to shareholders is driven by concerns that allocating capital into potentially sunset industries (oil and gas production) could leave investors with stranded assets on their hands (or assets with much lower values).

COVID seems to have accelerated this view. In contrast, STO has continued to pursue a growth agenda, whilst WPL continues to critically evaluate major multi-billion-dollar capital allocation decisions which will lift production rates.

The major miners of BHP Group (BHP), Rio Tinto (RIO) and Fortescue Metals Group (FMG) have also faced similar investor demands of greater near-term cash returns since the aggressive expansion of the 2010-2015 period. Today the focus is very much on the return of FCF to shareholders. Iron ore production growth is broadly flat over the next three years.

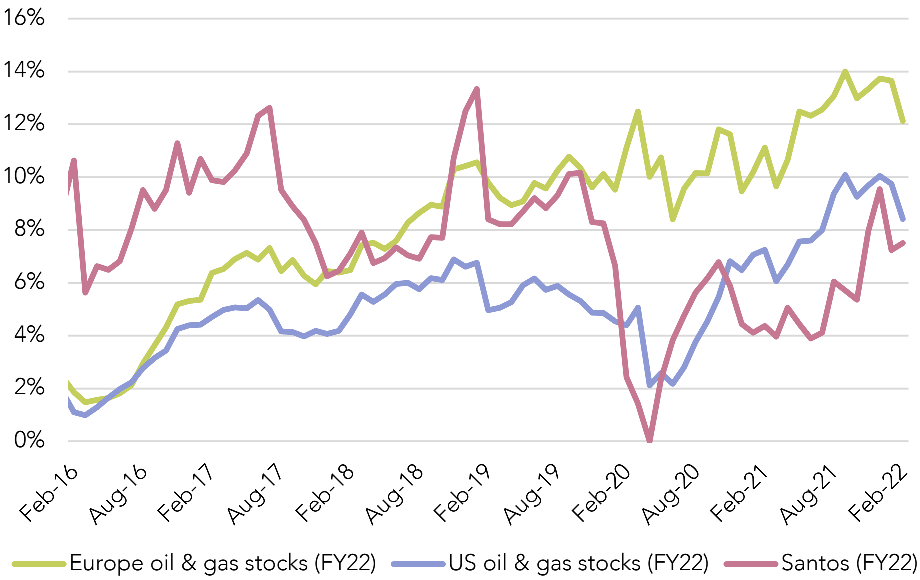
From a dividend perspective, the major miners have a materially higher dividend payout out ratio (and yield at current prices), which send a clear signal to investors on where cash will be deployed.

Exhibit 4: Offshore energy majors return more cash back to shareholders through higher dividends



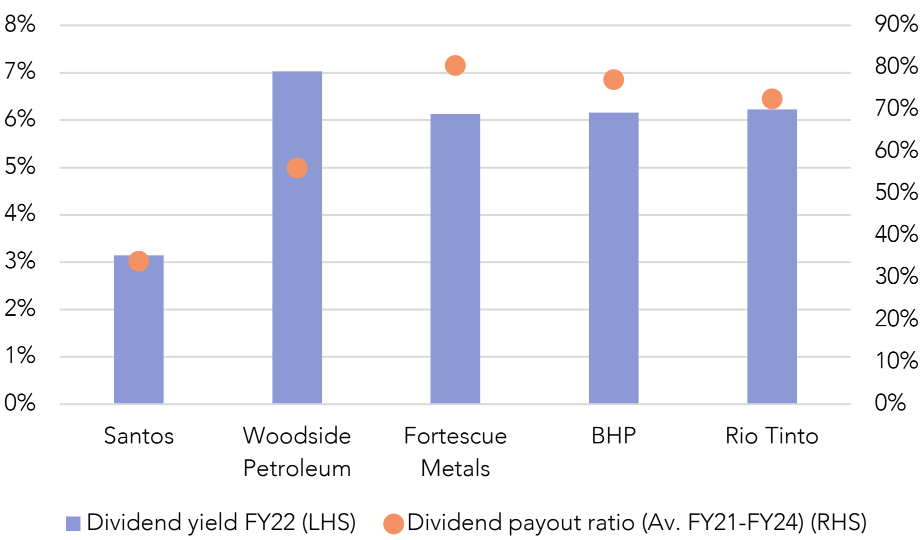
Source: Refinitiv, Wilsons.

Exhibit 5: Post COVID, STO FCF yield has lagged offshore peers



Source: Refinitiv, Wilsons.

Exhibit 6: Major miners and Woodside have much higher payout ratio vs Santos



Source: Refinitiv, Wilsons.

Rising Perception of Stranded Asset Risk

The prospect of investors being left with low returning assets in a sunset industry, or being left with stranded assets, has resulted in a valuation discount emerging in both STO and WPL. This valuation discount is apparent at both an absolute level and relative to the market.

Whether the Australian energy sector is more sensitive to stranded asset concerns relative to offshore is an interesting perspective, as the valuation discounts offshore do not seem to have held back the performance of European/ US energy companies to the same degree over the past two years. We believe the larger influence of this valuation discount is simply due to the higher growth rates that Australian producers are looking to pursue.

Exhibit 7: Australian energy sector now trades at a 20% discount to the market vs pre-COVID

Source: Refinitiv, Wilsons.

What Would a Higher Yield Santos Look Like?

Post the merger with Oil Search (OSH), STO now has the opportunity to address some of the capital allocation issues we have raised. The higher oil price and the recent performance of STO share price vs the market give the board room to consider a change in the company's capital spending framework. We think this could be the first task of new CFO Anthea McKinnell.

We think STO could lower its growth profile, lift its dividend payout ratio from 15-30% to 50% of FCF and still maintain an investment-grade credit rating. To help bridge the funding gap, asset sales could be used. We see the potential for >$2bn in asset sales. This could potentially double the dividend of STO.

Increasingly, the offshore development asset in Alaska acquired via the OSH merger looks like a non-core asset in the context of an Australasian energy company. Selling the Alaskan assets could raise $1.5-2.0bn at current prices in our view.

Changing the capital allocation framework and lifting the dividend would send a powerful signal to the market that growth is not to be pursued simply for growth's sake. It would lift the relative investor appeal of STO against both its offshore peers but also against the major miners, which have higher dividend yields.

We see an opportunity for Santos to address this framework at the upcoming results on 16 February. The Focus List has 5% weighting to STO. We continue to like the set-up for energy prices to move higher and the ability for STO to use self-help initiatives to release additional value.

Oil Price Outlook

The energy sectors relevance to Australian investors has diminished over the years. Today, the sector represents around 3.5% of the S&P/ASX 200, down from a peak of 8.5 in 2009-10. The two largest companies, STO and WPL, represent two thirds of the index following the merger of STO with Oil Search (OSH) in 2021.

Our constructive view of the sector is partially premised on an above-market call on the oil price. We see the oil energy market entering a period of tightness given by resurgent demand (noting IEA estimates for 2022 have global oil demand ahead of pre-COVID levels by 4Q22) and underinvestment in production assets. COVID accelerated the squeeze, as the CAPEX budgets of energy companies were cut during 2020-2021.

With global growth set to accelerate, along with the further reopening of the global economy (think airline travel, which represents 8% of global oil demand), we believe demand could exceed pre-COVID levels across 2023/24. Under this scenario, the market's assumption of oil prices reverting to $US60/bbl across 2023/24 looks too conservative.

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