



WILSONS

Energy Sector: Stronger for Longer

Our weekly view on Australian equities.

25 May 2022

Tight Market gets Tighter

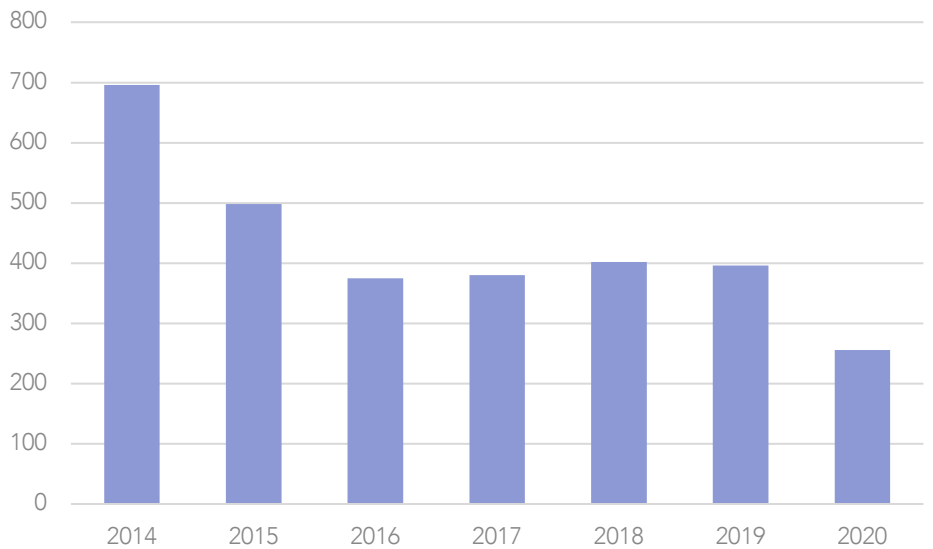
We expect the oil and gas markets to remain tight over the short to medium-term.

Energy markets were tight before the invasion of Ukraine, with limited capital expenditure in global oil and gas since 2014. Post-Ukraine, the market has become even tighter, and some of this lost production now looks as though it will be permanently removed from the global energy market. We think this adds another significant tailwind to the energy outlook over the next few years.

Oil and gas demand may moderate slightly as global growth slows, but we believe the loss of Russian oil will leave a significant gap in both markets. Uplifts in global production will take some time to offset Russian exports, leaving a significant supply deficit. **A stronger-for-longer outlook for oil and gas paints a bullish picture for energy stocks on the ASX.**

But we also like Australian energy for other reasons. **Energy has historically been an inflation hedge**, and while elevated inflation is not our base case, we think energy provides a portfolio hedge against this risk.

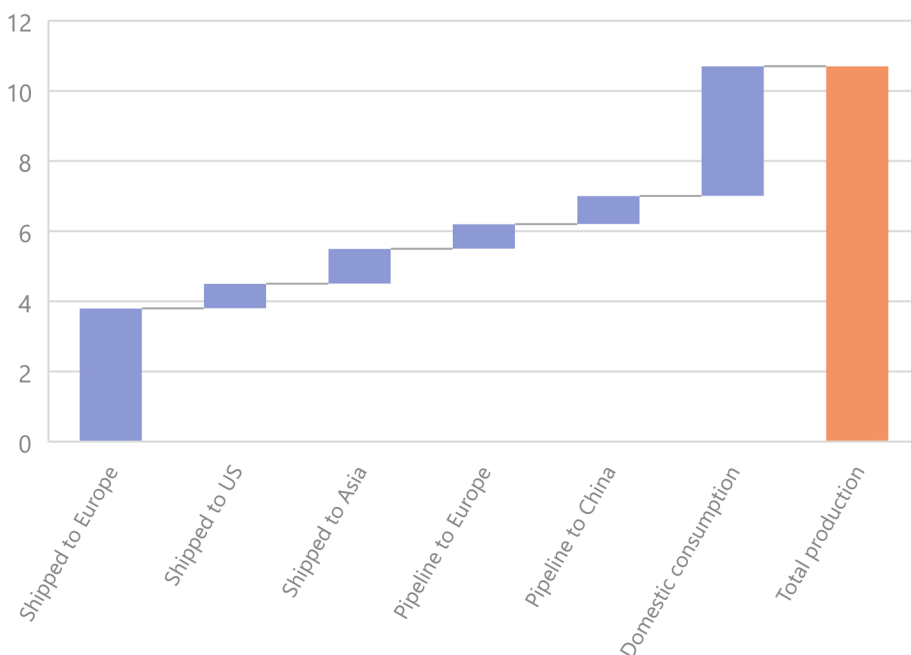
Figure 1: Global oil and gas capital expenditure has collapsed since 2014



Source: IEA, Wilsons.

Lastly, **Australian energy has underperformed its global peers.** We think this discount to global peers could be unwound over the next 12 months as companies' and investors' objectives become more aligned.

Figure 2: Breakdown of Russian oil production in 2021 (Mb/d). A significant amount of oil could be removed from global system with EU sanctions.



Source: Russia Ministry of Energy, UBS, Wilsons.

Russia-EU Decoupling

Following Russia's invasion of Ukraine in late February, early estimates indicated 3 million barrels per day of petroleum production - or about 3% of the world's production - had been effectively removed from the global oil market. This constituted one of the largest shortfall in supply since the 1970s.

Even as Russia's invasion of Ukraine enters its third month the oil markets are still roiled by uncertainty, just as they were at the beginning of the crisis. Oil prices are still more than \$100 per barrel due to the disruption of Russian volumes to the global market.

The European Union is preparing sanctions on Russian oil sales over its invasion of Ukraine after a major shift by Germany, Russia's biggest energy customer. Following a supply decline of nearly 1 mb/d in April, losses could expand to around 3 mb/d during the second half of the year as Europe starts to wean itself off Russian fossil fuels.

Eventually, OPEC+, the US and the Middle East, together with a potential slowdown in demand should be able to fend off an acute supply deficit; however, it will not happen overnight. We expect increased production to take some time to offset the loss of Russian oil and gas – Russia is 14% of the world’s total oil supply per annum.

In our view, the market has not priced in this scenario, with the oil forward curve mean reverting back to its historical average over the next few years.

Gas Market Could be Tighter than Oil

Russia's gas exports to Europe are still below average, and this has increased pressure on the global LNG market. Due to the long lead time for new LNG projects, prices are predicted to remain elevated as Europe tries to diversify away from Russian gas over the next few years.

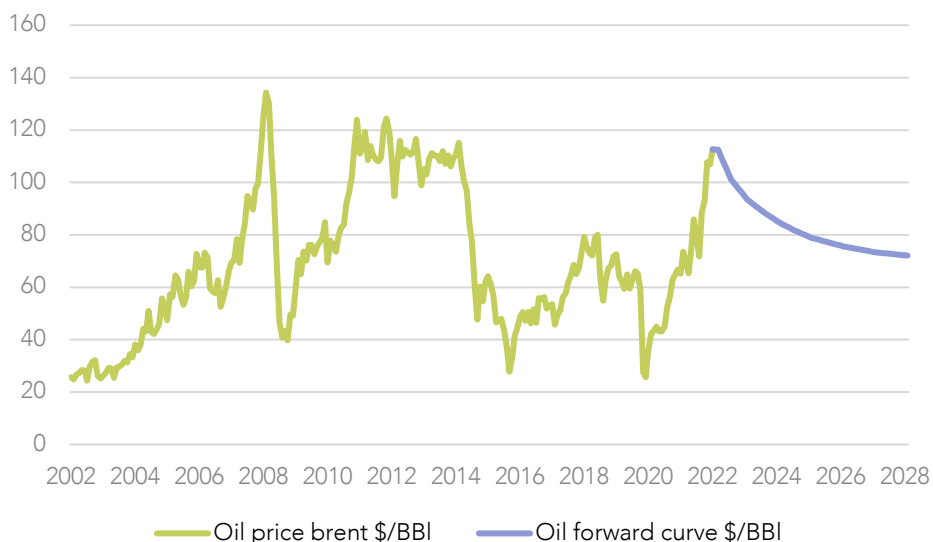
We expect, that European gas prices will remain high in the near future but will still gradually decline over the next three months as we enter warmer months in the Northern Hemisphere.

On a long-term basis, we expect the Russia-Ukraine war to have a greater impact on the global gas market than on the oil market. This will likely lead to tighter LNG markets and higher LNG prices.

Russia should be able to redirect most of its oil exports over time since oil is fungible. However, Russia cannot reroute its piped gas exports away from Europe without considerable capital spend.

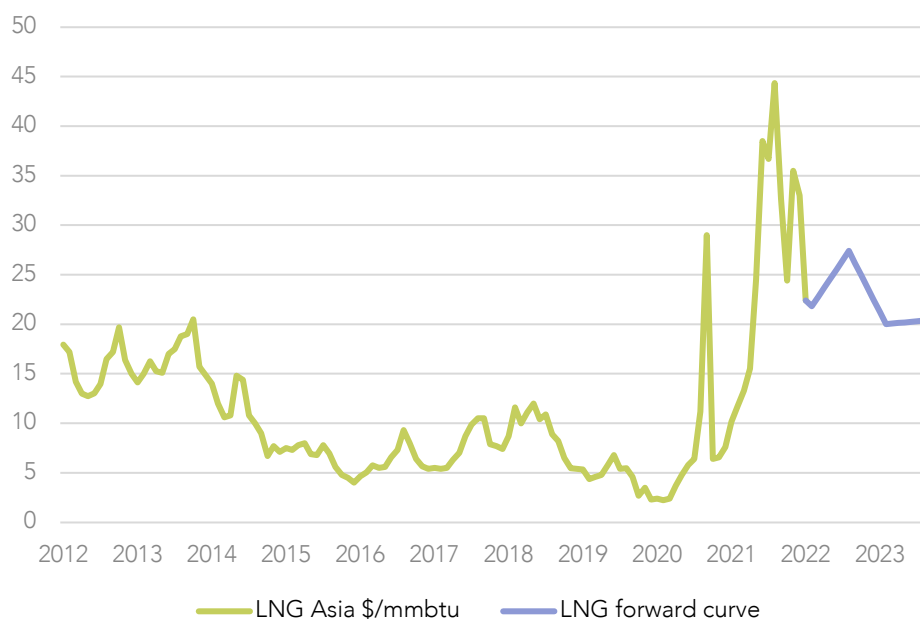
With the EU indicating that it plans to diversify its energy sources away from Russian gas over the next few years, we believe that Qatar, US and also Asian LNG will provide the bulk of alternative gas imports to the EU. Australian LNG will likely fill the subsequent gap in Asia. This is a bullish outlook for Australian LNG stocks like Santos (STO) and Woodside Energy (WPL).

Figure 3: The oil price is expected to revert closer to its historical average even with this potential supply shock



Source: Refinitiv, Wilsons.

Figure 4: The gas market may even be tighter than the oil market over the medium-term



Source: Refinitiv, Wilsons.

Energy Stocks Provide an Inflation Hedge

Historically, energy and resources have served as inflation hedges; while elevated inflation is not our base case, we believe energy provides a hedge against this heightened risk.

Our equity strategy in resources focuses on oil and LNG, gold and EV minerals as a way to hedge against inflation. Energy still remains our largest overweight in resources.

The majority of resource investors have already benefitted from the upcycle thus far, providing an opportunity for profit taking. However, we continue to recommend that investors remain exposed to the energy sector given current market fundamentals.

Underperformance Relative to Global Peers

Another key factor that keeps energy appealing is the continued underperformance to its global peers, despite Australian energy's outperformance against the ASX 200 this year.

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 +213%. Santos (STO) is +57% and Woodside (WPL) +27% on a price basis (May 20 vs May 22).

Over this period Australian energy company share prices have lagged offshore peers by over 30%.

We think both WPL and STO are likely to flourish over the next 12 months as company' and investor' objectives become more aligned, leading to an unwinding of the current discount.

For example, Santos is aiming to return more capital to shareholders with a new capital management strategy, while WPL's merger with BHP-P will provide strong FCF generation to support growth assets and increase shareholder returns.

Santos (STO) Still Our Preference

Our most preferred Australian energy exposure is STO. We expect a re-rate from various catalysts over the next 12 months. These include:

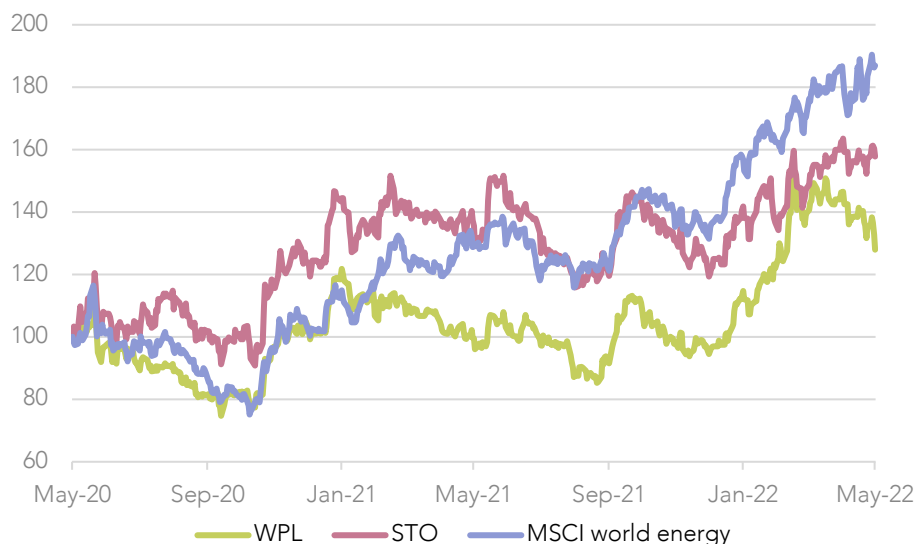
- Final investment decision (FID) on Dorado field (project off Western Australia). Development CAPEX estimated at \$2bn.
- Potential sell-down of 15-51% of the Alaskan asset. Potential proceeds of \$700m-\$2400m.
- Potential sell-down ~10% of the PNG LNG asset. Potential proceeds of US\$3-4bn.

The sell-downs allow STO to deleverage and implement its new capital management strategy. On 20 April, Santos announced a new capital management framework (including an on-market buyback of \$250m) targeting higher shareholder returns. This new framework lifts its dividend policy to 30-50% of FCF (previously was 10-30%) generated on oil prices up to US\$65, and a return of at least 40% of FCF to shareholders via buybacks and additional dividends for an oil price over US\$65.

This should substantially increase the capacity for further capital management over the next 12 months. Santos should generate \$450m of FCF for every \$10/bbl increment that the oil price is higher than Santos FCF breakeven, which has been guided to be \$25/bbl in FY22. At an average oil price of \$100 in 2022, this could be equivalent to an FCF of ~\$3.4bn, providing a capital return to shareholders of \$1.2bn by the end of the calendar year (including the \$250m already announced).

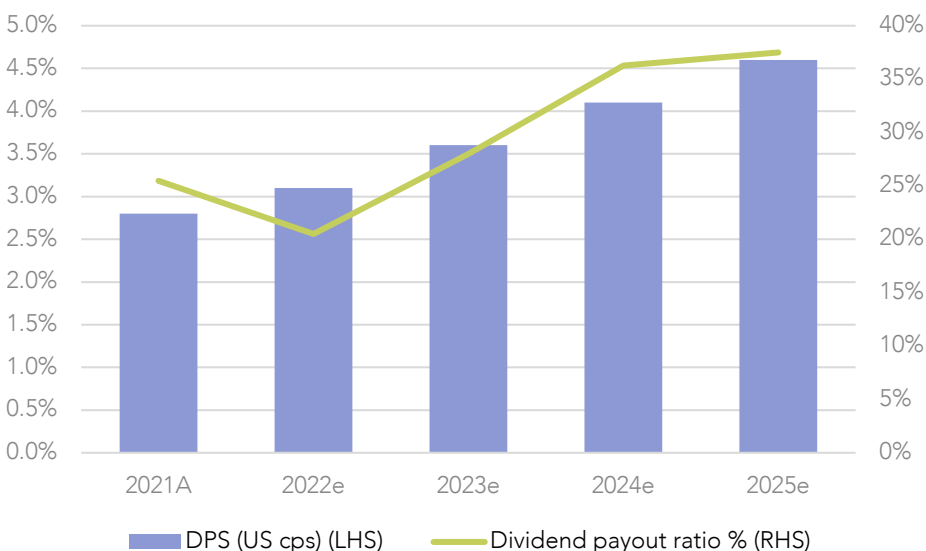
Santos is still one of the cheapest large cap energy stocks on the ASX – STO is trading with the lowest implied oil price at US\$63/bbl. We still believe there is significant upside to STO if oil prices stay elevated.

Figure 5: Australian energy stocks have continued to underperform global peers



Source: Refinitiv, Wilsons.

Figure 6: Dividend yields should grow significantly with STO's new capital management strategy



Source: UBS, Wilsons.

Woodside (WPL) Merger with BHP-P De-risks Stock

WPL is well positioned to benefit from the continuing oil and gas upcycle. In the Australian energy sector, WPL has one of the highest exposures to oil prices and spot JKM. We believe the merger between BHP-P and WPL provides substantial benefits to Woodside shareholders.

The BHP-P merger helps to de-risk Woodside on a number of fronts:

- **Provides a significant step-up in FCF, reducing concerns about WPL's ability to self-fund its growth plans.** Based on current UBS forecasts, BHP-P provides the group with an additional \$1.3 billion of free cash flow over the next 22-26 months, providing substantial support for WPL's major growth projects (Sangomar, Scarborough) and providing a path to sustainable shareholder returns.
- **Offers a wider range of growth projects and higher returns than WPL's stand-alone growth options.**
- **The merger will result in greater scale (effectively doubling production) and more product diversity.** Oil makes up 75% of BHP-P's production, which will raise WPL's share of oil and condensate from ~20% (now) to ~30%.
- **Synergies targeted at \$400m by management.**

At the current price, WPL is trading with the highest implied oil price amongst the large cap oil stocks at US\$67/bbl (stand-alone or 65/bbl combined with BHP-P). However, with an expectation that the oil price stays elevated for longer we will likely hold WPL after the merger with BHP. We also believe that WPL could re-rate as the market reacts to the potential benefits of the merger.

Figure 7: WPL's production will increase substantially after the merger with BHP-P

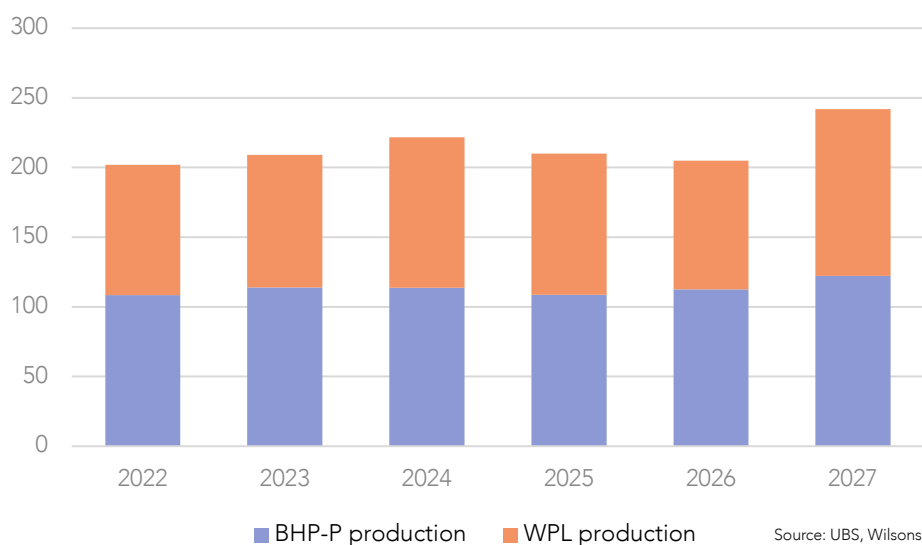


Figure 8: The merger maintains a higher FCF yield than WPL would as a standalone business

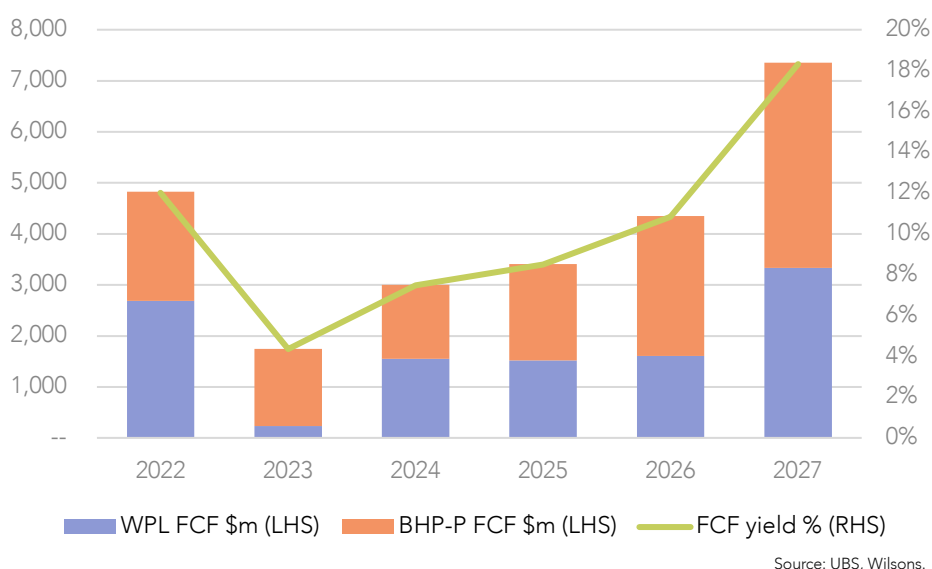


Figure 9: WPL vs STO Table

Company	Ticker	Consensus			At Spot US\$110/bbl			Uplift to Consensus	
		EPS FY23	PE FY23	DPS FY23	EPS FY23	PE FY23	DPS FY23	EPS FY23	DPS FY23
Santos	STO	0.70	8.3x	0.26	0.94	6.1x	0.30	34%	16%
Woodside	WPL	2.50	8.2x	1.63	3.89	5.2x	2.53	56%	55%

Source: Refinitiv, UBS, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

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

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