

OIL: THE FLOODS

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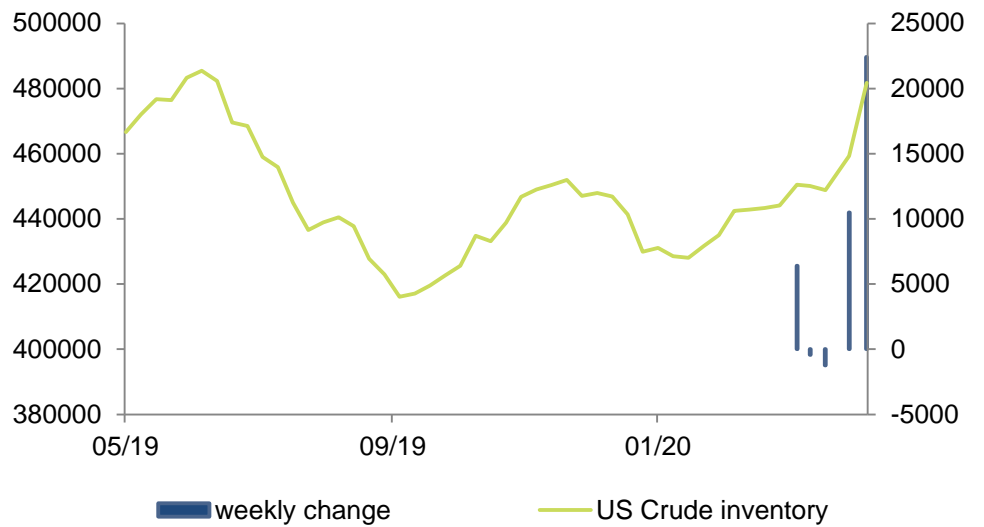
ALLIANZ RESEARCH

We expect significant volatility around our central Brent crude price forecast of USD 41/bbl as an unprecedented inventory build battles with a hope-driven news flow.

This week, API U.S. crude inventories show a second very large increase of 11.9mb. This follows from a record 10mb stock build last week. These numbers are only a glimpse of global inventories. The EIA estimates that oil demand could be in decline by 20mbpd. At the same time, indications are that Saudi Arabia is pumping in excess of 12mbpd, +up 1.5mpd. We see scope for further output growth from Saudi Arabia of at least another 1mbpd, and another 3-4mbpd from other producers. With this, we expect a prolonged period of rising inventories.

Global oil storage capacity, estimated at c 6mb, might get exhausted in less than one quarter if pessimistic demand estimates come true, according to our calculation. This could lead to negative oil prices at times and forced production shutdowns. The same holds for the resumption of talks between Opec and Russia. To be meaningful, any agreement would have to foresee production cuts in the order of 10mpbd. Given the three-way nature of the oil-price war, the U.S. remains an important factor. Whether or not brokered by the U.S., the inclusion of the U.S. industry in administered production cuts seems less likely, though largely for cartel law issues. This could prove a stumbling block for a deal and lead to other forms of escalation between the parties.

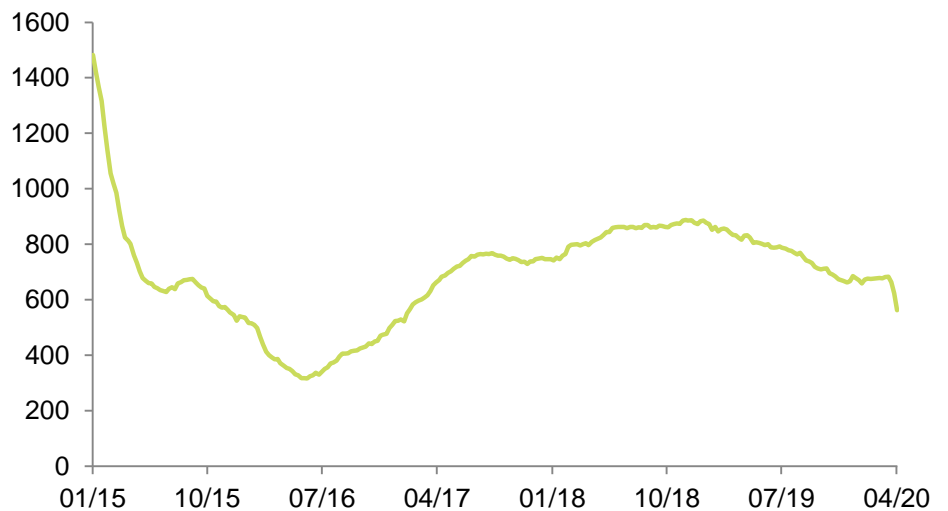
Figure 1 – U.S. crude inventories



Source: API

U.S. rig count is declining in reaction to falling oil prices, with sequential falls over the last three readings. This has brought the rig count down by 121 or 17%. The last reading was down 62, heavily weighted towards the Permian Basin. Output is still very high at close to a record 13m. Producers may need to continue to meet production commitments for various contractual and operational reasons. Looking back at the 2014-16 precedent, U.S. output declined by just 0.2mbpd, and with a six month lag, in reaction to a USD 70/bbl price decline. A similar reaction today would suggest production declining by just short of 0.3mbpd in reaction to prices only, insufficient for any price impact.

Figure 2 – U.S. oil rig count



Source: Baker Hughes

Companies globally are impacted by acute cash flow strain. Across the sector, cash preservation measures such as dividends and a collective USD 20bn in capex cuts have been announced. For a number of companies, this will not suffice. U.S. shale in particular is exposed due to high debt levels. While break-even costs for the most competitive assets are in the low USD 30s/bbl, a great number of smaller scale assets require much higher oil prices. The circular logic in the sector means reduced capex will reduce operating cash flow due to lower well production.

A number of companies have begun debt restructuring. Whiting was the first shale producer to file for chapter 11 since the beginning of the Covid-19 crisis. A large number of bonds trading between four and thirty cents on the dollar imply default. Meanwhile, the increase in non-investment grade yields means a much higher cost of refinancing where this is even possible in an environment where investors have cut back on investment in the sector, and oil prices do not provide any incentive for fresh capital injections. The levels of the last shale crisis could be exceeded: In 2016, the U.S. independent sector saw 20 bankruptcies and the sector 70 major insolvencies (source: Bloomberg/EH) as a result of the price of Brent halving. Within our U.S. independent sample, 40% of companies had already exhausted more than 50% of available credit lines and 30% more than 65% at the end of Q3 19 (source: Bloomberg/EH), levels that are likely to have risen since. As a result, we anticipate 30% of companies could face risk of insolvency. Looking at it another way, on budget and break-even estimates, we gauge that 60% of production may be unprofitable or below budget. Given the concentration of competitive assets amongst large companies, this would again underpin a 30% risk ratio.

That being said, large companies are not immune: witness the hiring of debt advisors at some very large names. We note inklings that the U.S. government may be willing to impose tariffs on Saudi and Russian oil imports in order to support the industry. This comes alongside potential strategic purchases, both measures novel for the sector. Note that shale oil not only provides jobs but is a strategic industry in terms of energy independency and U.S. geopolitical objectives. This will not be keep it completely safe, though.

Difficulties are also drawing in Canada, the North Sea and other higher-cost resources that are unprofitable at current prices. In these areas, companies have begun to warn about debt-related difficulties. Furthermore, if companies choose to shut in production in reaction to negative oil prices and/or lack of storage capacity, this could mean damage and increased cost to assets in the long run.

These assessments are, as always, subject to the disclaimer provided below.

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