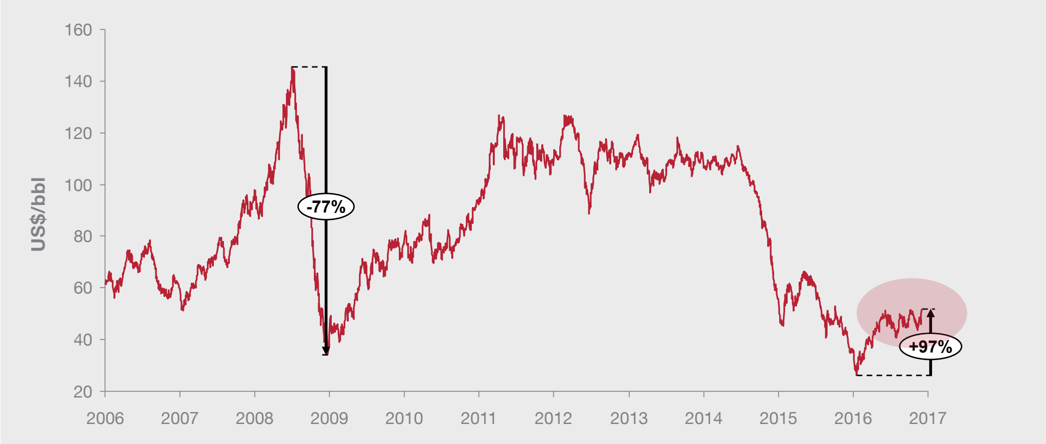
Oil Price Update

Q4 2016

Gradual market rebalancing begins but risk of oversupply lingers

Brent Crude Daily Price January 2006 - November 2016



Source: Bloomberg; Strategy& research

Global oil supply and demand – edging towards equilibrium

The Brent crude spot price continues its recovery. It is now some 97% higher since the low in January 2016 of US$27/bbl. The informal OPEC meeting in Algiers in September 2016 where a production cut was announced provided an additional fillip to the price recovery. And more recently at the Vienna meeting on November 30th, OPEC confounded sceptics by agreeing to cut production by 1.2m bbls/d which had an equally positive impact supporting oil prices (Brent rose by 13% - nearly US$6 – between December 1st and November 29th close of business).

From a fundamentals perspective, we are witnessing a gradual rebalancing of supply and demand. The massive over supply that characterised the global oil sector for the past of couple of years is beginning to ease off. For example, lower oil prices have seen US oil production decline by 10% equating to some ~954,000 bbls/d. However, this is somewhat offset by some OPEC members (prior to the OPEC Vienna meeting) continuing to produce at full tilt (such as Saudi Arabia at 10.6m bbls/d, Iran at 3.7m bbls/d and more recently UAE at 3.1m bbls/d). It is also worth noting that Russia continues to defy expectations producing at a post Soviet high of 11.1m bbls/d (bearing in mind it has agreed in principle to cut production by 300,000 bbls/d to meet the recent OPEC cut).

On the demand side, growth is slowing. Consumption from China and India is easing off as the stimulus from cheaper oil is fading. Global oil demand is forecast to grow by 1.3m bbls/d in 2016 which according to the IEA is a downgrade of 0.1m bbls/d on their previous forecast. Momentum is likely to ease further in 2017 with demand growing at 1.2m bbls/d, as weaker macroeconomic conditions undermine growth prospects.

Industry data suggests that by the end of 2016 and mid-2017, supply and demand should be more closely balanced. That said there are still some headwinds to contend with in the sector. On the supply side we still see significant inventory levels, approximately 3.1bn barrels, which will take time to draw down and will have a dampening effect on an oil price recovery. Note nevertheless, we have seen two consecutive months of decline in inventory.

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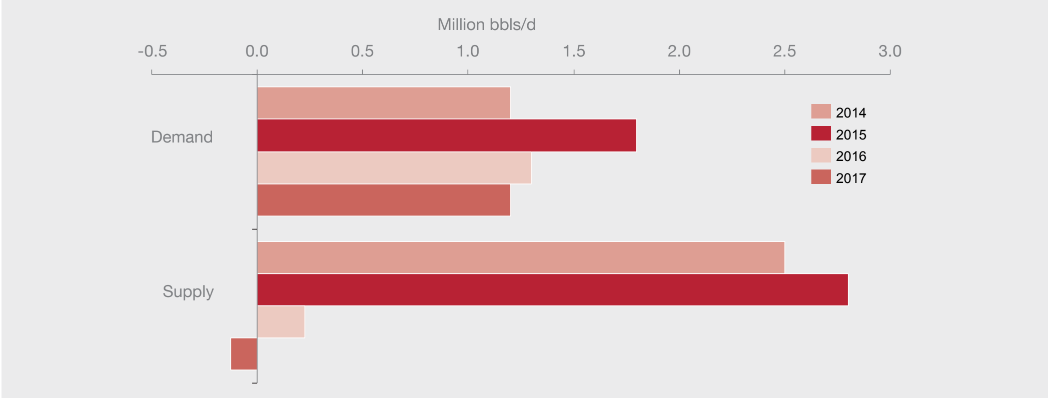
World Oil Supply and Demand Growth YoY Change 2014-2017



Source: IEA Oil Market Report; Strategy& research

Additionally, with some OPEC producers currently producing at very high levels (Saudi Arabia and Iraq to name a few), OPEC's spare capacity has declined to around 1.1m bbls/d. In the event of an unexpected supply disruption, OPEC may struggle to 'plug the gap', raising the spectre of price shocks. Bearing in mind the industry faces a potential supply crunch, given the reduction in capex and deferred projects, this could further exacerbate a price shock.

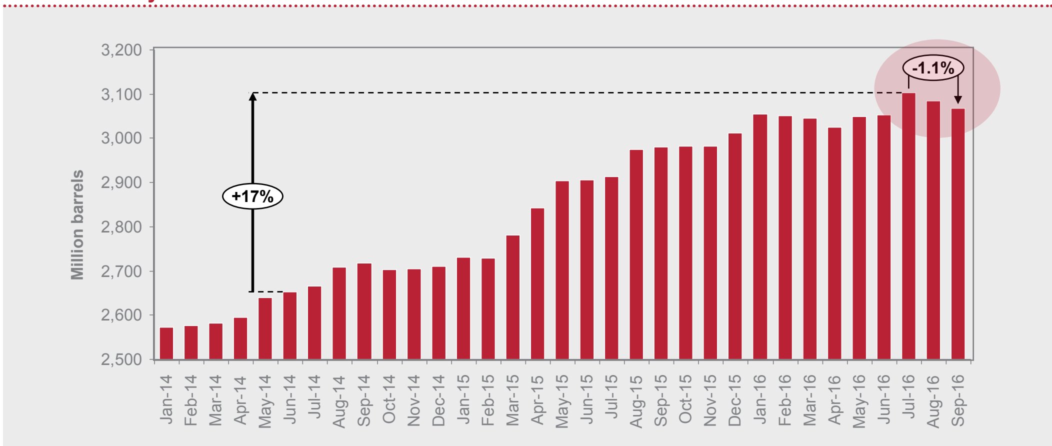
OPEC – has the prodigal son returned?

OPEC's decision to announce a production cut in Algiers caught many commentators by surprise. Moreover, some industry observers noted it was great to see OPEC returning to its traditional role of a 'market manager'. Oil prices certainly benefitted from an immediate fillip when the announcement was made, with Brent rising some 6%. However, at the time, two key questions remained unanswered: could OPEC deliver the cuts and would it be enough? As it transpired, at the November 30th meeting in Vienna, OPEC delivered another surprise, overcoming internal dissent to announce a cut of 1.2m bbls/d. Certainly the scale of this reduction is enough to provide a short term fillip to prices and markets will welcome this decision. However, the question remains – can OPEC deliver on this promise and will it be enough to provide a sustained uplift to oil prices? Time will tell.

Will the wave of consolidation finally come? – perhaps not just yet

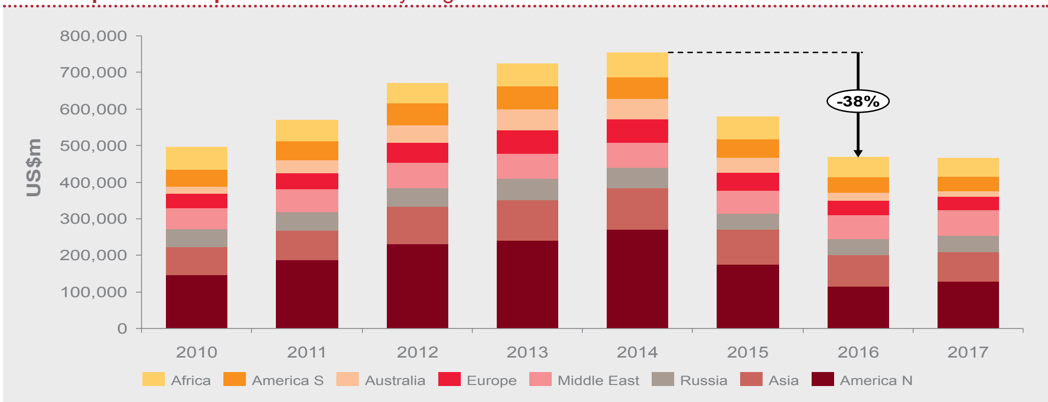
In this period of low oil prices and severe financial distress there has been much talk of an imminent wave of consolidation that will sweep the sector. To date it has not materialised – or at least nothing akin to the M&A activity that spawned the super majors in the late 1990s and early 2000s, and nor for that matter the surge in M&A the global chemicals sector is currently witnessing. Part of the issue has been oil price volatility with buyers and sellers unsure on what the floor price is. This has not precluded some activity including a number of transformational deals such as Shell acquiring BG or the FMC / Technip merger. However, should we see prices stabilising, as they appear to be doing so, this may trigger a wave of consolidation across the sector. Moreover, given the 'lower for longer' oil price scenario, there is an element of sellers' price expectations coming down, thus narrowing the gap to foster more transactions - particularly for the companies that are in financial distress.

OECD Industry Stocks 2014 - 2016



Source: IEA Oil Market Report October 2016; Strategy& research

Global Upstream Capex in Oil & Gas By Region



Source: Rysted Energy; Strategy& research

Cost reduction will remain a focal point for the sector

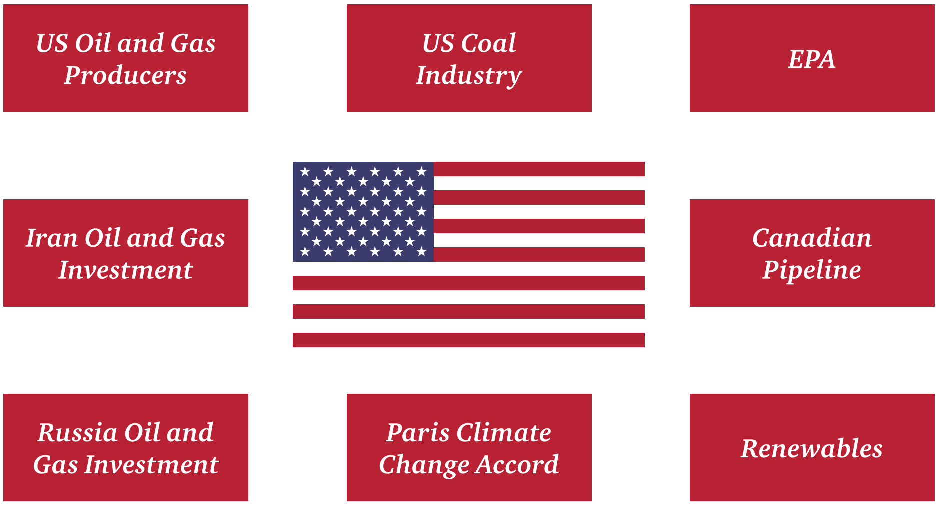
The sector remains focused on cost reduction, pulling the traditional levers during a downturn. Headcount is being reduced, major projects deferred or cancelled, rates with service providers aggressively discounted and capex reduced. According to data from Rystad Energy, global upstream capital expenditure is forecast to decline by some 40% between 2014 and 2016. Moreover, this will have been the first time global upstream capex will have shrunk in two consecutive years, illustrating the severity of this downturn. There are regional variations to this decline. Europe, N America and Australia will witness the largest declines in capex while the Middle East will see the least.

What about the Trump effect?

There is limited detail on Donald Trump's energy policies (some of the key themes are highlighted below). However, it is clear energy will play an important role in helping shape Trump's central vision to "make America great again." Aside from his pledge to make the US energy independent, Trump will be keen to use revenue from energy production to rebuild national infrastructure and create jobs.

From an international oil and gas perspective there are some broad ramifications we can perhaps highlight. The US oil and gas sector will likely benefit from a pro-oil Trump administration and as a result US oil and gas output may likely increase. Trump's hostility to the lifting of sanctions on Iran may see more punitive sanctions re-imposed. If so this would weaken the case for foreign investment in Iran and adversely impact Iranian aspirations to grow oil production further. Conversely, Trump's apparently warmer relations with President Putin may see a weakening of sanctions and increased foreign investment. All these scenarios will have implications for global oil supply in addition to the main driver which remains supply and demand fundamentals.

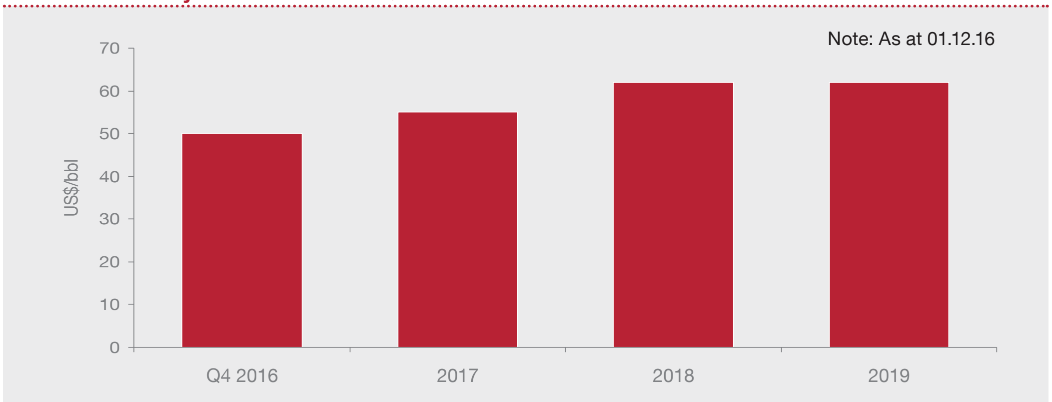
Selected Energy Themes Impacted by Trump Administration



So what next for oil prices?

What is certain is that prices will continue to be extremely volatile as industry fundamentals seek an equilibrium. Oil prices are likely to recover but slowly. Analyst forecasts suggest prices may reach US$60/bbl+ by 2018.

Brent Crude Analyst Price Forecast Q4 2016 - 2019



Source: Bloomberg

If you would like to discuss any of the areas covered in this briefing, as well as any opportunities or implications for your business, please contact:

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