

Oil Market Report: November 2019

Millwall FC and Saudi Aramco would seem, on the surface, to have little in common. But in many ways, the favoured New Den chant of “no-one likes us, we don’t care”, could just as easily be applied to the state oil company of Saudi Arabia...or indeed the oil industry as a whole! On the eve of Saudi Aramco’s Initial Public Offering (IPO), many commentators have expressed surprise that there should be widespread investor interest in a company that not only produces the least popular product on the planet, but also a product whose future is constantly being called into question. Add to that, the fact that Aramco operates in a dictatorship with an opaque judiciary and the ever-present threat of revolution, and many are scratching their heads in disbelief.

Such a view however overlooks the mighty scale of the oil industry, the breath-taking profitability of Aramco and the confidence of the Saudi Royal Family in backing the company’s resilience in the face of a future decline in demand. First and foremost, the oil industry is still comfortably the biggest in the world and even if it was to halve in size, it would still be larger than (for example) the collective global metals market (iron, steel, gold, aluminium etc). As for Aramco itself, the company is the most profitable on earth by a factor of 2 to 3 times, outgunning the combined profitability of ExxonMobil, JP Morgan, Alphabet (Google) and Facebook. In the first 9 months of 2019 (when oil prices have been fairly flat), Saudi Aramco delivered profits of \$68bn. Its nearest rival was Apple, which in the same period “only” made \$35bn. The world may desire electrical fruit, but it would seem it needs filthy oil more.

Investors are well aware of these facts and interest in Aramco’s share offering has been correspondingly intense, with an incredible 25 Investment Banks involved in the process. In “crude” terms, when it comes to a company like Aramco, money talks and investors are rarely sentimental when it comes to hard returns.

But there is more to Aramco than its current staggering ability to make money and the floatation by the Saudis is both shrewd and bold. Yes, it is true that oil may be on the “last lap” of the global energy race, but in so many areas, it remains, and will remain indispensable. Cars, buses and maybe trucks can all shift to alternative power sources, but planes and ships cannot do so easily. Plastics, chemicals, fertilisers and pharmaceuticals all have few alternatives to the intense use of oil. More significant still is the fact that as demand for oil declines, so will investment in oil exploration, which will leave gaping holes in the relationship between supply and demand. Whereas demand moves in a linear and entirely predictable fashion, oil supply will disappear in “chunks”, as oil companies cease investing in new projects. This will result in large and damaging price spikes, which will of course massively benefit the producers that keep investing and producing...

Step forward Saudi Aramco! In a “last-man standing” scenario, all sensible bets would have to be on Aramco. At an average oil extraction cost of \$5-10 per barrel, it is unlikely their operations will ever be unprofitable – whatever the oil price. And when there are price spikes along the way, bumper dividends will be generated for shareholders. Furthermore, low extraction costs are a reflection of the low energy required to get Saudi oil out the ground, which actually makes Aramco’s operations highly efficient and environmentally friendly versus the likes of Russian heavy crude or even American shale. In an environmentally conscious future, this kind of “green” factor could be extremely important to “necessary” buyers of crude.

All of which means that whilst the Oil Majors are now desperately trying to reinvent themselves as Energy Companies (with renewable solutions thrown into the mix), Aramco has no real reason to do anything but get the stuff out the ground and sit tight. All the while, competitors will likely fall by the wayside, picked off by shrinking demand, high production costs and aggressive environmental legislation. The fact that Crown Prince Muhammad bin Salman is holding out for a \$2trn valuation – rather than the current likely value of \$1.5trn - is merely investment tittle-tattle. A \$1.5trn valuation will still make Saudi Aramco the world’s biggest company by market capitalization (easily surpassing Apple’s current value of \$1.15trn) and even though only 2-3% of shares will be made available, this will still generate \$30bn for the Saudi Treasury. Much more will no doubt follow, when further shares are released in 2020.

Readers can make their own judgements as to whether the Saudi Royal Family are showing far sighted judgement with their IPO or whether they are simply the lucky rulers of a country blessed with bounteous oil reserves, that are located in geologically basic rock formations. Either way, Saudi Aramco’s share offering allows us to cast a light on what the oil sector might look like in 20 years’ time, when demand has fallen and alternative forms of energy are in the ascendancy. One conclusion might be that the industry in 2040 will be made up of multiple small players serving the niche products that still come from crude oil. Crown Prince bin Salman is banking on an alternative view, where one giant player dominates what is left of the oil industry. On Dec 11th, we will see whether investors believe that the player in question will be Saudi Aramco.

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Our Trainees have played a big part in Portland's progress over the last 10 years. Check out our video that "celebrates" their achievements (1st video); <https://portland-fuel.co.uk/portland-10/>

