Integrated Oil & Gas Outlook 2019: Credit risks balanced as strategic challenges intensify

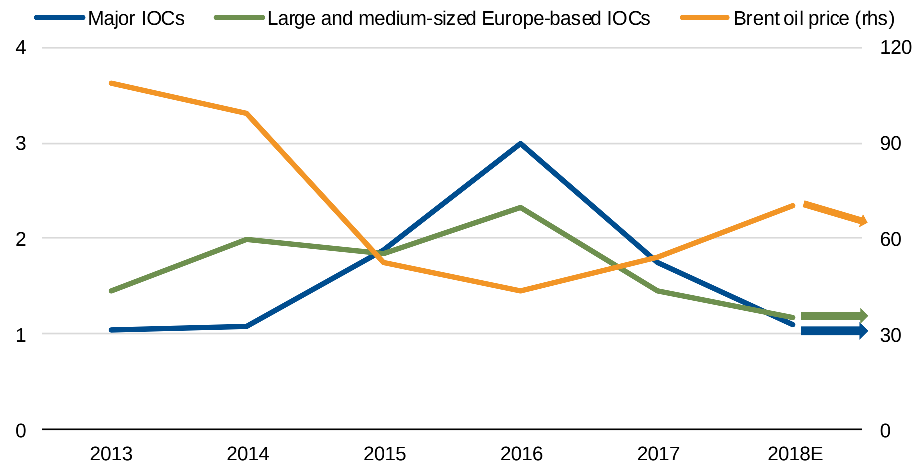
Integrated oil and gas companies (IOCs)[1] are in good financial shape to cope with likely volatile markets in 2019, but credit risks could re-emerge given the longer-term strategic challenges of adjusting to less predictable political, regulatory and technological trends.

Scope Ratings says the sector's credit outlook is stable for 2019. However, much depends on what mix of financial and operational strategies companies adopt to contend with uncertain external conditions.

The successful optimisation of capital expenditure, operating expenses, and shareholder remuneration has made IOCs more resilient to possible price shocks today than before the previous slump in crude prices. With the sector back to generating free cash flow, those companies with lower break-even levels in their upstream business and stronger exposure to downstream are expected to perform most robustly.

Sector debt is already close to or within individual corporates' target levels, so corporate treasurers are unlikely to use their financial headroom to further reduce borrowing. Shareholders, on the other hand, could well see improved returns, as companies switch back to cash from scrip dividends, and even raise them, if oil prices remain between at least USD 60 and USD 70 per barrel.

Figure 1: Median leverage – Scope-adjusted debt/Scope-adjusted EBITDA (x) – within Scope's peer group and Brent oil price (USD/bbl)



Source: Company reports, Bloomberg, Scope

Pressure on IOCs' upstream business to secure low-cost resources and keep costs under control remains constant. There is also pressure on downstream to shift into higher value-added production. The situation is further complicated by the need to find new or expand existing low-carbon activities, amid a growing investor focus on sustainability and renewed regulatory concern in Europe, if not the US, on greenhouse gas emissions. For now, IOCs are diversifying into different technologies. However, it is worth noting that none of them is allocating much more than 10% of investment to low-carbon activities.

[1] Scope analysed the five oil Majors – BP plc, Chevron Corp, Exxon Mobil Corp, Royal Dutch Shell plc, TOTAL SA – and the large and medium-sized Europe-based integrated producers: Eni SpA, Equinor ASA, Galp Energia SGPS SA, MOL Hungarian Oil and Gas plc, OMV AG, and Repsol SA.
Please note that general trends for IOCs (such as lower break-even prices or historical leverage dynamics) are also applicable to pure exploration & production players. However, pure exploration & production players are generally more sensitive to oil prices and have higher leverage, resulting in a faster expected pace of deleveraging than IOCs.

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Macroeconomic environment: volatility may be the only constant

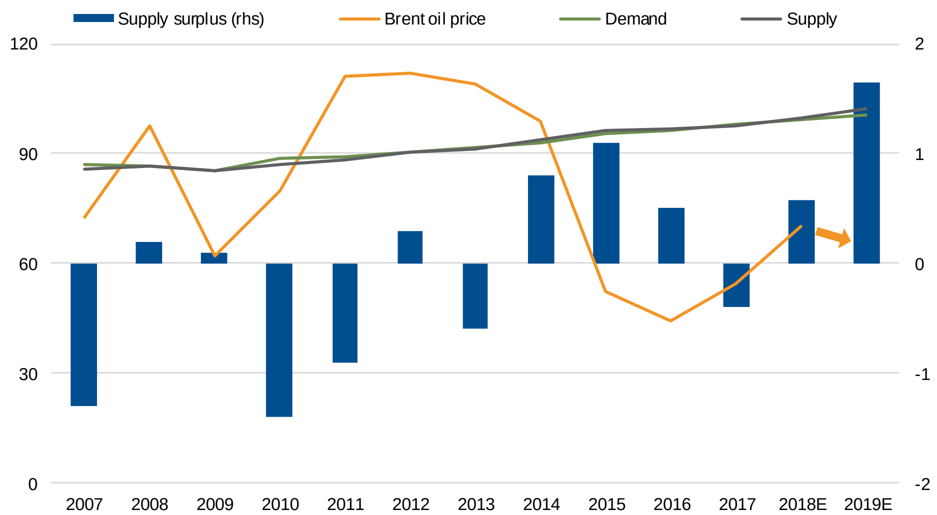
Scope's main forecasts for 2019 are:

- Moderately lower oil price levels than in 2018 with Brent averaging between 60 and 70 USD/bbl
- On average stable or slightly increasing refining margins (also driven by MARPOL 2020 low-sulphur emissions regulation towards the end of 2019) and petrochemical margins (mainly driven by strong demand growth)
- High volatility in prices and margins

The International Energy Agency estimates global oil demand growth at 1.4 mb/d in 2019. This is mainly driven by global economic growth, which is, however, subject to a number of risk factors such as trade tensions, tightening financial conditions, and the vulnerability of some emerging markets and developing economies.

Global oil supplies are growing rapidly, as record output from the top three producers (Saudi Arabia, Russia and, in particular, the US) more than offsets declines from Iran and Venezuela. There is projected supply overhang, assuming constant OPEC output throughout 2019. However, it is expected that Vienna Agreement countries (also known as OPEC+) will agree on production cuts to balance the market and support oil prices.

Figure 2: Global oil demand-supply balance (million barrels per day) and Brent oil price (USD per barrel)



Source: International Energy Agency, Bloomberg, Scope

The path to free cash flow recovery

Oil prices remain the most important factor in determining IOC financial performance.

We expect leverage, defined as the ratio of Scope-adjusted debt to Scope-adjusted EBITDA, to be close to or even below pre-downturn levels through 2019.

The recent slump in oil prices, which began in the second half of 2014, highlighted several important trends:

- Despite including exploration & production focused players such as Eni and Equinor, European peers had more stable leverage. This is mainly due to their stronger exposure to downstream operations (refining & marketing, petrochemicals) and more restrictive shareholder remuneration on average. While all Majors are privately owned, most of the Europe-based IOCs have significant or even controlling government shareholdings (excluding Repsol) resulting in more conservative financial policies on average.

- The majority of our peer group stopped share buyback programmes (typically the oil Majors), cut dividends (typically the Europe-based IOCs) or introduced scrip dividend programmes (typically Europe-based Majors).

- Following the substantial deflation in the market for oilfield services and efficiency initiatives, the IOCs reduced investment spending by a third on average while maintaining output levels or even increasing them. The oil Majors achieved cuts of around 40%; Europe-based IOCs achieved cuts of around 25% as they invest more in growth than the major IOCs.

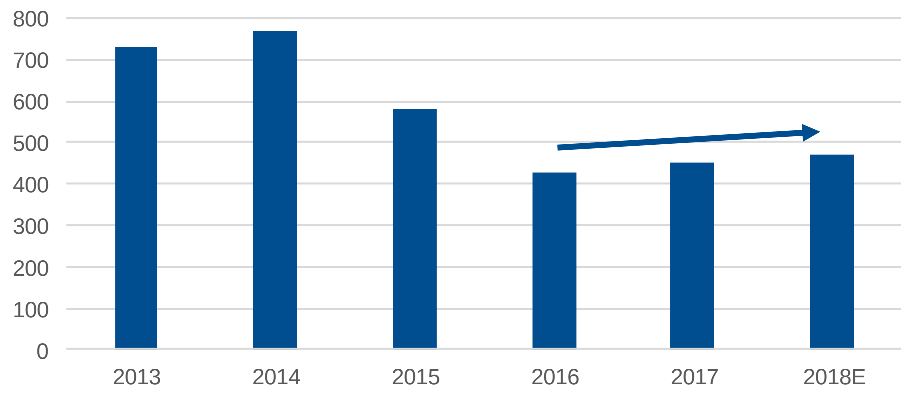
- The sector was able to cut operating expenses substantially.

Together with the dividend cuts, companies in Scope's sample reduced their cash-neutral oil price (the price that is required for operating cash flow to cover organic capex and dividends) by half, to close to or below 54 USD/bbl in 2018 (equivalent to the average price of Brent crude oil in 2017). The launch of new projects, with even lower break-even levels, is expected to bring this price down still further.

Repsol, OMV, MOL and Galp have the lowest cash neutral oil prices in our sample peer group, mainly due to their low-cost resource base in upstream and strong exposure to downstream. This supports our view that business models are now more resilient to external shocks, provided that financial frameworks remain flexible with no excessive cash distribution.

As a result, and supported by the oil price recovery, IOCs returned to free cash flow generation in 2018 if not earlier. The new operating expenses and capital expenditure structure has made them more resilient to lower energy commodity prices then pre-downturn. However, spending discipline remains vital for their performance, especially because there is already growing evidence of moderate cost inflation.

Figure 3: Global oil and gas upstream capital spending (USD bn)



Source: International Energy Agency, Scope

The challenge: how to best utilise the financial headroom

In our base case, we assume that the oil price is above the cash neutral oil price. The options for using the excess cash this affords are: debt reduction, a dividend increase, share buybacks, and growth investments including M&A.

Debt levels are already close to or within the target levels/ranges as defined or indicated by companies, hence our expectation of modest further deleveraging at best.

Some companies (e.g. Shell, Equinor) have cancelled the scrip dividends introduced in the last downturn, and started to increase ordinary dividends (Chevron kept stable dividends during the downturn; Eni and OMV did so after dividend cuts during the downturn), some announced share buyback programmes (Shell, Chevron, Total in 2018; Eni may follow next year) – though typically these are conditional on crude prices.

IOCs are focusing capital expenditure on expansion or investments ultimately aimed at the long-term transformation of their activities:

- Securing low cost oil and gas reserves (e.g. ExxonMobil, OMV, Repsol)
- Downstream expansion and/or high-grading (MOL, OMV, Repsol)
- Increased but still limited focus on low-carbon businesses. Here, the leaders are Europe-based IOCs such as Total, Repsol, Shell, Equinor. The laggards are US-based majors like ExxonMobil and Chevron.

We expect continuing M&A activity in the industry, mainly motivated by:

- Portfolio high-grading (typical for Majors), focused growth and synergies/economies of scale (e.g. BP's purchase of BHP Billiton's US shale business, Eni Norge and Point Resources merger to Vår Energi)
- Investments in growth/transformation also include low-carbon businesses (e.g. renewable energy, alternative fuels and mobility solutions as part of the energy transition) and technology (process and cost optimisation through digitalisation, robotics and automation), where the purchase of expertise is usually more appealing than inhouse development.

Some companies are combining various approaches (e.g. ExxonMobil, MOL and Repsol are expected to increase both investment and shareholder distribution).

With uncertain times ahead, IOCs are in better shape than pre-downturn

IOCs have returned to free cash flow generation and are now more resilient to price shocks than pre-downturn. Those companies with lower break-even levels in their upstream business and stronger exposure to downstream are expected to perform more robustly.

We expect some of the excess cash to be distributed to shareholders via higher dividends or share buybacks (a key trend among Majors) or spent on growth projects (a key trend among Europe-based IOCs). There is also an increased but still limited focus on low-carbon businesses. We do not expect significant further debt reduction as target levels have been already achieved or are within reach.

We see more volatility in energy commodity prices which would have the following consequences depending on the overall trend:

- Higher prices: provided a strictly controlled cost base and efficiency initiatives continue, any windfall profits would be predominantly distributed to equity holders or invested in growth projects. This implies a negligible or only modest improvement in credit quality.
- Lower prices: IOCs are operationally more resilient compared to pre-downturn levels. They can therefore sustain price levels in the lower USD 50/bbl range for Brent crude oil without a material deterioration in their credit metrics, provided they adopt flexible shareholder remuneration and investment plans.
- Either way, we see no material impact on credit quality from moderate volatility of oil and gas prices.

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