OCTOBER 2022

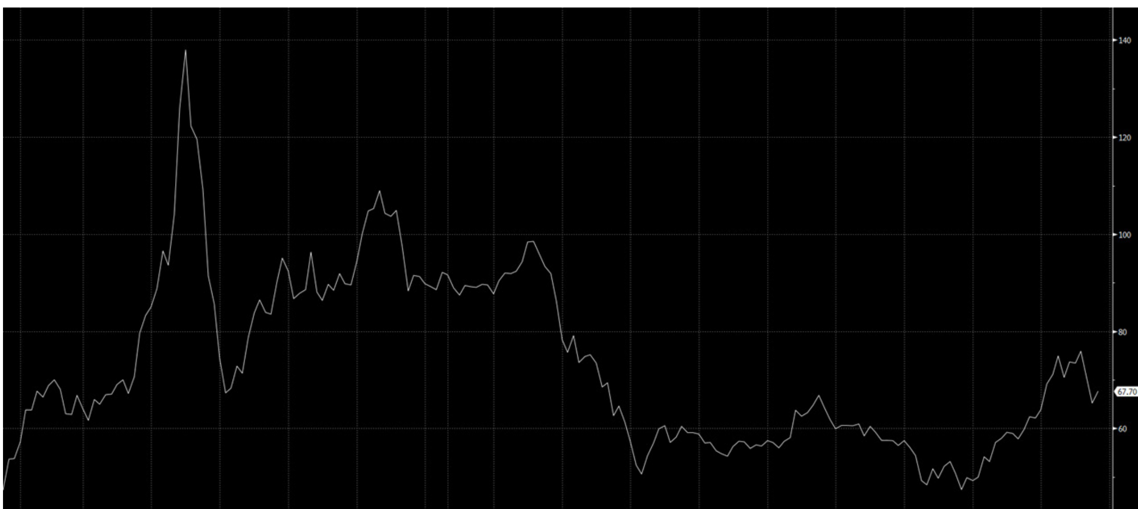
DRIEHAUS EMERGING MARKETS GROWTH STRATEGY

Opportunities in the Energy Sector

2022 has represented a perfect storm for global energy markets, as Russia's invasion of Ukraine has resulted in significant shifts in trade flows, accompanying rising uncertainty about the future supply of oil and natural gas. These developments occurred following several years of underinvestment, leaving the world with critically low levels of spare capacity. In this piece, we address how we got to this point, where we believe we go from here, and how the Driehaus Emerging Markets Growth Strategy is positioning within the energy sector.

Following the Global Financial Crisis (GFC) in 2008, the oil price staged a strong initial rebound, as the world recovered from the crisis in tandem with multiple rounds of interest rate cuts and quantitative easing by global central banks. However, as a result of low interest rates and technological innovation in the energy sector, significant capital investment unfolded in US shale, leading US oil production to grow from 5.5 million barrels per day (mbd) to 9.5mbd between December 2009 and June 2015. As US production rose, OPEC abandoned its traditional role as a market balancer in late 2014, accommodating the new supply growth without cutting its own production, a move which sent long-term oil prices down sharply (Exhibit 1).

Exhibit 1. Long-Dated (60-month) Brent Crude Oil Price ($/barrel)

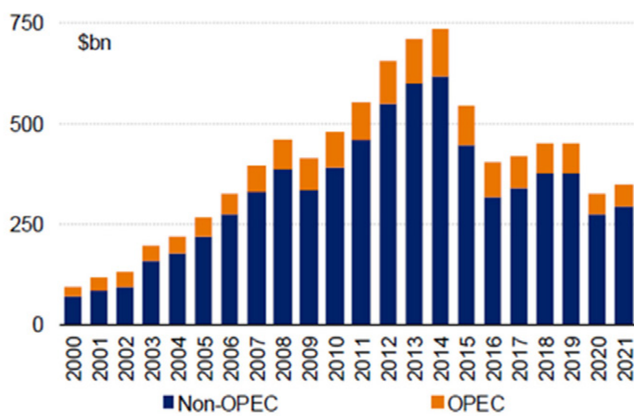


Source: Bloomberg

As long-term oil price assumptions serve as the primary input for most capital investment decisions by oil and gas exploration and production (E&P) companies, new investment in upstream oil and gas cratered, nearly halving from its peak of $750 billion in 2014 to a level that has not been seen since 2007 (Exhibit 2).

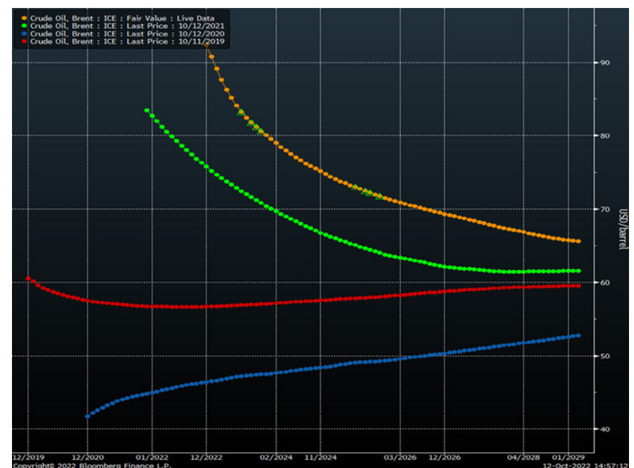
The cumulative effect of several years of underinvestment is that the world now maintains extremely low spare capacity. Complicating matters, 1/3 of the total spare capacity is located in countries that are currently under sanctions, and the rest is controlled by a cartel (OPEC).

Exhibit 2. Upstream Oil and Gas Capex (Nominal)



Source:Woodmac

Exhibit 3. Evolution of Brent Crude Oil Forward Curve Between 2019-2022

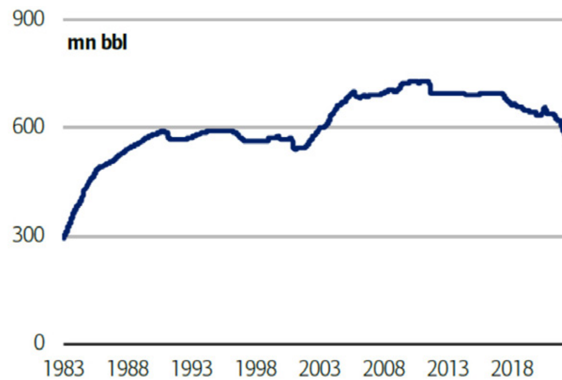


Source: Bloomberg

Where do we go from here? Recent analysis by Bank of America concluded that "$80 is the new $60" for long-term oil prices, based on policy decisions recently undertaken by the US and OPEC, alongside rising global inflation. This is important for a couple of reasons. First, if oil and gas E&Ps adopt similar long-term oil price assumptions, this portends a backdrop of rising capital expenditures in the sector, which would augur positively for oil service companies. Second, this analysis implies that the forward curve for Brent crude oil is underpriced (Exhibit 3). Long-term oil prices correlate closely with energy sector valuations, and an upward shift in the curve would imply scope for positive earnings revisions.

Oil prices reached a near-term peak in June, pulling back from a high of $125/barrel to touch as low as $85/barrel in late September. There have been two major drivers of this pullback, which temporarily led oil balances into surplus. First, US Strategic Petroleum Reserve (SPR) inventories have recently been depleting rapidly, as the US has sought to bring down inflation (Exhibit 4). Second, China's oil demand has been growing below trend, resulting from lockdowns and ongoing disruptions related to the maintenance of the zero-COVID strategy (Exhibit 5).

Exhibit 4. US Strategic Petroleum Reserves



Source: Bloomberg

Exhibit 5. China Implied Demand for Oil

Source: Bloomberg

We view both of these headwinds to the oil price as temporary, and looking ahead, as they inevitably normalize, we expect the oil market to return to deficit, at a time when inventories are already at multi-year lows (Exhibit 6). Further, OPEC has now returned to its position as a market balancer, recently cutting production to support prices against the threat of a downturn in demand, should parts of the world experience a recession.

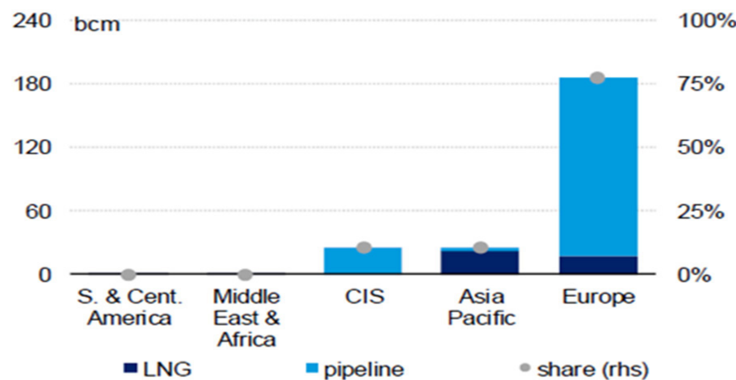
Exhibit 6.Oil Stocks to Use Ratio

Source: Bloomberg

Translating this positive view on energy fundamentals into the portfolio, the Driehaus Emerging Markets team is finding opportunities in the energy sector in three main segments – E&Ps, oil service companies, and areas tied to rising demand for liquefied natural gas (LNG). Additionally, we expect that rising concerns about a multi-year energy crisis will serve to accelerate efforts by policymakers for the development of renewable energy and electric vehicles, and the Strategy continues to hold companies with strong technologies and market positions in these areas.

While the Russia-Ukraine war has added to volatility and uncertainty within the oil market, the impact on oil supply has been minimal thus far, as oil has been mostly redirected away from trading companies who have self-sanctioned purchases of Russian oil, as well as US and UK buyers, whose governments have explicitly adopted sanctions. The same does not hold true for natural gas, as we have seen a phased curtailment of Russia's supply to Europe starting in June and culminating with the recent Nord Stream pipeline sabotage (Exhibit 7).

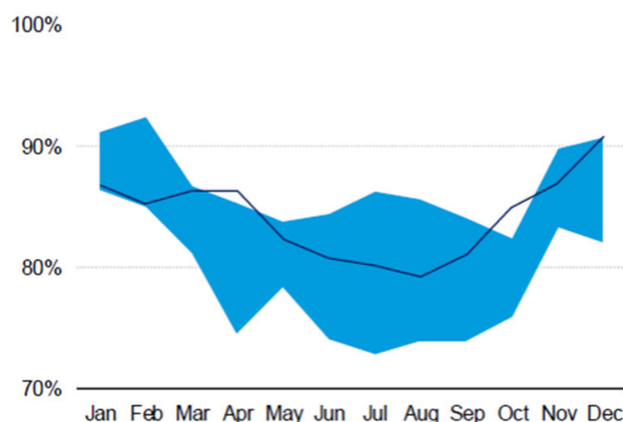
Exhibit 7. Russia Gas Exports



Source: BP Statistical Review

Natural gas is much more challenging to redirect, as it requires either pipeline or LNG infrastructure, both of which are long lead time investments with no idle capacity today. Consequently, global LNG markets have rapidly tightened, and substantial new investment in infrastructure, ships, and the production of LNG is expected to unfold in the coming years (Exhibit 8). The Strategy maintains positions in a Korean shipbuilder and a Qatari LNG shipping company that are poised to benefit from the structural growth of LNG.

Exhibit 8. LNG Capacity Utilization



Source: Bloomberg, BofA Global Research

Prior to 2022, energy equities had suffered over a decade of underperformance, leading investors to increasingly shun investments within the sector. However, consistent with the Driehaus investment philosophy, which is centered around inflection points and earnings revisions, we have found some of our strongest performing stocks in the energy sector over the last two years. While we acknowledge that these companies will continue to hold a cyclical earnings profile, we expect the high degree of underinvestment, low level of spare capacity, and relatively inelastic demand to support strong earnings growth, which we believe is in the early stages.

ABOUT THE AUTHOR

Chad Cleaver, is the lead portfolio manager of the Driehaus Emerging Markets Small Cap Equity strategy and a portfolio manager for the Driehaus Emerging Markets Growth and Driehaus Emerging Markets Opportunities strategies. His idea generation, security selection, portfolio construction, and risk management responsibilities, and macro-level analysis, are leveraged across the three strategies managed by the Driehaus Emerging Markets Team.

Mr. Cleaver began his career with the Board of Governors of the Federal Reserve System and joined Driehaus Capital Management in 2004. He received his A.B. in economics from Wabash College in 2000 and his M.B.A. from the Kenan-Flagler Business School at the University of North Carolina at Chapel Hill in 2004. Mr. Cleaver is a CFA charterholder.