Schroders

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Schroder ISF[1] Global Energy
Fund update
September 2019

Fund performance

For the month of September, the fund posted a return of +2.5%, which compared to the MSCI World Energy benchmark return of +4.61%.

Year to date, the fund returned -7.92%, which compared to the MSCI World Energy benchmark return of +6.15%.

Calendar year performance

US$ %	2006[1]	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD 2019
Fund	6.87	48.43	-54.48	80.63	17.47	-18.28	-7.63	12.31	-31.00	-36.59	38.59	-7.43	-21.85	-7.92
Benchmark[2]	4.82	31.16	-38.05	26.23	11.88	0.17	1.87	18.12	-11.60	-22.80	26.56	4.97	-15.84	6.15

Source for performance: Bloomberg I Accumulation shares USD gross. Performance is on a NAV to NAV basis. [1]Inception 30 June 2006. [2]MSCI World Energy. Typical ongoing charges for C shares are 1.30%.

Past performance is not a reliable indicator of future results, prices of shares and the income from them may fall as well as rise and investors may not get the amount originally invested.

Risk Considerations

The capital is not guaranteed. Investments denominated in a currency other than that of the share-class may not be hedged. The market movements between those currencies will impact the share-class. Where the fund (or the manager) holds a significant percentage of the shares of one or more companies, it may be difficult to sell those shares quickly. It may affect the value of the fund and, in extreme market conditions, its ability to meet redemption requests upon demand. The fund will not hedge its market risk in a down cycle. The value of the fund will move similarly to the markets. The derivative strategy is applied repeatedly over three-monthly periods. This strategy will increase the income paid to investors and reduce the volatility of returns, but there is the potential the performance or capital value may be eroded. The fund enters into financial derivative transactions. If the counterparty were to default, the unrealised profit on the transaction and the market exposure may be lost.

Market commentary

Global oil market

The oil market experienced pronounced volatility in September as Saudi Arabia suffered a direct attack on it oil facilities. Brent oil prices started the month at around $60/bl and then spiked to $69/bl immediately after the attacks were announced and then they drifted back to $60/bl by the end of the month.

The fact that this attack 'potentially' came from its close neighbour, Iran, we think it underpins a new political risk premium in the global oil market. Before provide some details behind the attack, let us step and back and address how balanced the oil market is now.

From an inventory perspective, the oil market is tight, very tight. At 550mln barrels, global inventories are roughly 10% below normal for this time of year and depending on the true extent of damage to Saudi Arabia's Abqaiq facility, further draws are expected in Q4 2019.

However, for Q1 2020 the oil market will need to absorb a lot of crude as a very high level of non-OPEC fields' start-up. This is illustrated in the table below. There are around 700k/day of mega oil projects starting up between November 2019 and June 2020 (Svedrup, Buzios and Liza highlighted in the table below) and barring a strong recovery in demand (not our central case) large builds in crude over this period seem almost unavoidable.

In total, new non-OPEC field start-ups of 1.6mb/day is actually in line with the last few years, and below the horrible over supplied period of 2014 to 2016, the problem is, the majority of these field start-ups are crammed into a relatively short window and we would expect this to put some pressure on front month crude prices over this period.

[1]Schroder International Selection Fund is referred to Schroder ISF throughout this document.

Non-OPEC field start-ups in 2020

Field Name	Country	Size
Johan Svedrup Ph. 1	Norway	350
Buzios 3	Brazil	180
Buzios 4	Brazil	150
Atapu South	Brazil	150
Liza Phase 1	Guyana	120
Al Shaheen	Qatar	100
Martin Linge	Norway	80
Krishna Godavari	India	80
Sunrise Phase 2B	Canada	70
Kuyumbinskoye	Russia	60
Other Small Projects		240
Total Capacity (kb/day)		**1,580**

Source: Company data, EA – September 2019.

Beyond this near term 'oversupplied' window, there are two bullish factors that cannot be ignored.

Firstly, let us address the recent attacks on Saudi Arabia's facilities. The attacks, which both the US and Saudi Arabia believe were caused by Iranian representative's, took out roughly 5.7mb/day of crude oil processing capacity (5.5% of global oil supply).

Saudi Arabia recently claimed that 2.5mb/day of this disrupted output is back online and that full capacity will return by end-November. Run cuts and crude stock draws to help maintain exports of 7mb/day, but they are already indicating that October loadings to be below normal and in addition Aramco's crude stock levels are below original estimates (at just 60mb versus previous estimates of 140mb – 180mb).

In light of the November 2020 IPO, there remains deep scepticism in the market as to whether these are credible timelines offered by the Kingdom. Engineering experts claim the damage alone should have taken weeks to assess, especially with workers only allowed back in the Abqaiq complex for the first time on the 25th September.

In light of these attacks, three things are clear:

a) They add to the risk of destocking at a much faster pace in Q4.

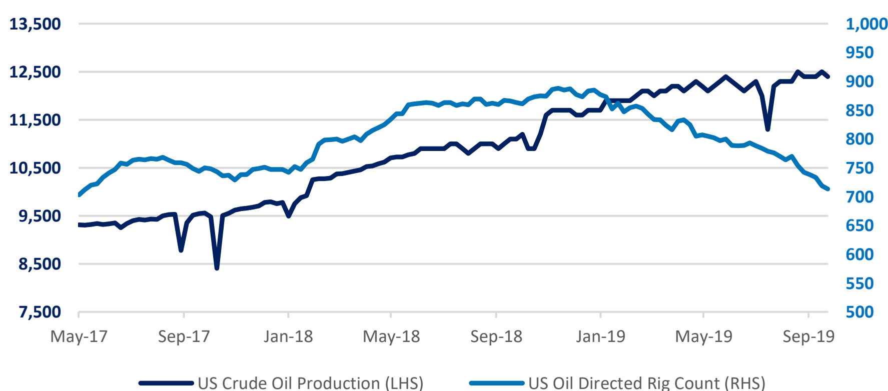
b) They almost completely remove the risk of Iran sanctions being eased and that production coming back onto the market.

c) It will restore some political risk premium back into the global crude prices.

The second bullish factor is shale oil production. Over the past few years, US onshore oil production from shale has experienced considerable growth and has essentially kept the oil market oversupplied at the expense of the OPEC members keeping production in check.

However, the last 6 months has seen a considerable change in mind-set from the operators. They are no longer chasing growth, free cash is the mantra and as a result, despite WTI oil prices holding above $55/bl, the US oil directed rig count is falling sharply. This unprecedented level of capital discipline is discussed in more detail in the equity section of this monthly report.

US oil production (kboe/day) vs. US onshore rig count



Source: Bloomberg – September 2019.

The US oil directed rig count is now down 20% year on year and as we head into 2020, just like in 2016, we expect US production to start falling from Q2 2020 onwards.

Following the oversupplied period in Q1/Q2 2020, this slowing US production dynamic potentially sets up for a very tight oil market in the second half of 2020, but in the first half of 2020, the market will have to absorb the high level of non-OPEC project start-ups first.

Energy Equities

Despite the spike in oil prices, energy equity performance was disappointing during the month. During the 2 days after the attacks, the US oil and gas sector and European oil and gas sectors both jumped around 10% on a considerable amount of short covering, but following the retracement of oil prices, both of these energy subsectors have given up almost all of these intra-month gains.

Despite the record free yields and strong balance sheets, sentiment towards energy equities is extremely negative. In the mid cap energy space (which is where the Schroder global energy fund is invested) valuations are cheap and management teams have assets bases that paying healthy dividend yields to investors, but this has not led to generalist buying.

In addition, conversations around ESG (environmental, social and governance) investment considerations have grown considerably in the past few months. This is reflected in high profile announcements of sovereign fund divestment, demands from clients, and conversations between investors and company management. Over the last few months, ESG has been another headwind for conventional energy investment, as it has subdued optimistic sentiment, and gives generalists a reason to limit their energy exposure to a bare minimum, and own nothing outside the integrated majors and refiners.

We attended the Barclays global energy conference in September and taking into consideration the actions and messages from these oil and gas equity management teams, it was very difficult to have a bearish outlook. Below is a summary of broad macro and company themes taken from the meetings with company management teams.

- US oil drilling activity will decline further throughout Q3 and 'settle' in Q4. WTI oil prices falling further towards $50/bl will prompt a further and much sharper slowdown.
- Oil production growth estimates for 2020 will continue to be revised downwards. Current forecasts are for US onshore oil production growth of around 1.2 - 1.3mb/day, based on what the companies are saying (and doing), this looks impossible. Year on year US onshore liquids growth of around 0.7 - 0.8mb/day looks much more appropriate.
- US gas drilling activity will also continue to fall throughout Q3 and further in Q4 if no recovery in prices are seen towards $3.00/MCF.
- Due to the fall in NGL prices back below 30% of WTI, marginal NGL drilling activity has also collapsed. This is positive for US natural gas prices. As associated gas volumes will slow in 2020.
- Gas production growth out of the Marcellus and Delaware is slowing fast and the extent of the slow down is being underestimated by analysts for 2020 forecasts. Again, this is positive for US natural gas prices.
- North American oilfield service sector is in a state of low utilisation and over supply across its two key product lines - land rigs & pressure pumping – is causing some firms to finally close operations after sustaining losses for a long period.
- Despite many service providers in this area losing money, these service lines are experiencing further pricing pressure, with price cuts of 5 - 10% being taken by marginal, almost bankrupt providers. Halliburton, Schlumberger and Patterson are not reducing prices; they would rather not chase utilisation. They all expect a new wave of bankruptcies (like 2015) across the sector.
- The oilfield service space is starting to divide, with large service providers trying to differentiate through the technology of their product offering, and move towards a more capital light and data heavy business model. This has also resulted in a general shift in emphasis from the North American markets to international.
- The oversupplied service market is helping the US E&P companies to maintain their margins and free cash generation. Despite these price reductions, E&P companies are not chasing growth. The focus is giving the excess free cash to shareholders.
- Many E&P management teams (Devon, EOG, Noble, Marathon etc.) are stressing that the dividend payments are sustainable and a priority for management teams. They are focused on keeping their dividend yields above that of the S&P 500.
- Despite consolidation (at nil premium) making sense, M&A has not been rewarded by the market, partially reflecting scepticism for any delay in free cash flow or dilution of a clear path to sustained generation of free cash flow, debt repayment and share buybacks.
- Capital expenditure plans at current prices (between $50 - $60/bl WTI) indicate that discipline is holding.
- International oilfield service activity continues to pick up slowly from a very low base. Oil projects are not driving this activity. LNG tendering activity is very strong and a big focus in the Middle East is on domestic gas growth.
- There are now clearly two markets for debt in the E&P and oilfield services sector. The companies that are well capitalised and don't need debt have full access to cheap debt, which they can term out for 5 – 10 years. However, companies that currently have Debt / Ebitda metrics of 2.5x and above are considered high risk and pricing of any near term maturities, (that need rolling over) is horrible.

In summary, energy equity management teams are wholly focused on giving free cash back to shareholders. These management teams know that they have to behave differently in order to attract generalist investors and if they succeed, the extent to which this sector outperforms the broader market could be substantial.

Top fund holdings summary

We model all energy companies using the forward curve for Brent and WTI for three years forward followed by a 'normalised' price of $70/bl and $65/bl for Brent and WTI respectively and long-term gas prices at $3.40/mcf. This is slightly below the average cost of production for the industry as a whole to sustain a cost of capital return based on the analysis of non-OPEC production costs.

Below is a snapshot of our top 20 holdings in the portfolio. The portfolio continues to hold a 37% weight in the US E&P sector and 18% weight in the oilfield services sector. These weights are 25% and 12% above benchmark respectively.

Taking into consideration these companies free cash yields and ROCE, the fund has never looked so cheap on a cash flow multiple basis vs the MSCI energy index and vs the broader market. The average DCF upside (using $65/bl WTI long term) is also the highest we have seen for many years.

Schroder Global Energy Fund - Top 20 holdings

Table I: Schroders Global Energy Fund top 20 overweight positions

	% Weight	2020 Price/cash flow	Last reported % Gearing	Fair value (SIM)	% Upside
ENI	6.88%	3.82x	14.0%	22.67	62.0%
Royal Dutch Shell B	6.37%	3.85x	19.8%	28.66	19.7%
Schlumberger	6.29%	8.01x	26.6%	58.04	72.0%
Galp	6.01%	5.42x	22.3%	28.41	106.6%
Cimarex Energy	4.23%	2.77x	17.1%	140.74	196.9%
Noble Energy	3.95%	3.55x	36.2%	43.66	99.4%
Devon Energy Corp	3.91%	3.92x	27.8%	52.22	117.3%
Marathon Oil Corp	3.87%	2.98x	25.0%	35.62	190.9%
BP	3.57%	3.61x	29.6%	8.52	65.4%
Apache Corp	2.97%	3.14x	45.9%	53.73	112.7%
Suncor Energy	2.94%	5.63x	25.6%	56.44	37.1%
Cenovus Energy	2.80%	4.64x	32.4%	19.19	56.7%
Eog Resources	2.76%	4.88x	19.0%	102.34	38.7%
Repsol YPF	2.71%	3.37x	19.0%	25.93	81.5%
John Wood Group	2.68%	4.27x	25.4%	7.48	98.8%
Canadian Nat Resources	2.49%	4.14x	38.5%	62.12	76.9%
WPX Energy	2.42%	3.01x	36.6%	28.14	164.5%
Halliburton Co	2.31%	5.55x	47.0%	39.34	108.6%
Gran Tierra	2.11%	1.80x	23.5%	6.55	306.6%
Centennial Resource	1.73%	1.86x	17.2%	13.18	203.6%
Total	**72.99%**	**4.01x**	**27.4%**		**110.8%**
MSCI World Energy Index		**5.58x**			
S&P 500 Index		**11.57x**			

Source: Schroders, Bloomberg Consensus – September 2019.
Stocks shown are for illustrative purposes only and should not be viewed as a recommendation to buy or sell.

Commodity subsector performance

The US oilfield services index (OSX) increased by 4% whilst the European oilfield services index (BEUOILS) increased by 1.2% in September. At the end of the month, the fund held around 17% exposure to the global oilfield services sector.

The US exploration and production index (XOP) increased by 3.7% and the Canadian E&P index (STOILP) increased by 11.3% during the month in US dollar terms. The fund held around 43% exposure in the global exploration and production sector at the end of September.

The US integrated index (S15IOIL) increased by 2.1%, while the European Oil & Gas index (SXEP) increased by 4.6% during the month. In addition, the US independent refiners index (S15OILR) increased by 12.9%. The fund held around 36% exposure to integrated and refining companies at the end of September.

Portfolio attribution and activity

The fund underperformed both the MSCI World Energy mid cap and MSCI World Energy index in September. Our positive attribution from core positions in E&Ps, such as Cimarex, Apache, and Devon, were more than offset by other E&P positions that struggled, including Antero, Premier, Noble, Centennial, and Gran Tierra. Similarly, our Oilfield Service exposure saw mixed performance. Schlumberger and Trican was up against the benchmark, providing around 15bps of outperformance, but this was offset by positions like Petrofac, TechnipFMC and Wood Group. Chevron and Exxon both underperformed the benchmark considerably this month, helping fund performance by approximately 58bps. Our put options eroded performance by about 34bps, given the SPX index's resilience in September.

Commodity price assumptions for company modelling

	2018A	2019F	2020F	2021F	2022F	2023+ LT (normalised)
Schroders Brent ($/bl)	70.92	61.41	61.83	61.78	65.89	**70.0n**
Brent Forward	70.92	61.41	61.83	61.78	62.01	
Schroder WTI ($/bl)	65.47	53.33	54.66	54.70	59.85	**65.0n**
WTI Forward	65.47	53.33	54.66	54.70	54.77	
Schroders Henry Hub Gas ($/mcf)	3.03	2.88	2.71	2.63	3.07	**3.50n**
Henry Hub Forward	3.03	2.88	2.71	2.63	2.65	

Source: Schroders – September 2019. Schroders assumptions for oil at 100% of forward strip to 2019, fading to 2022 normalised year.

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