An Deeply Unloved Sector and Deep Value Investing

COLLINS ST
SPECIAL SITUATION FUND NO.1

There are few sectors as maligned as fossil fuels at the moment, and within the sector few are as distrusted as offshore oil producers.

A combination of ESG considerations and a pre-emptive drop in supply to match forecast demand has seen the sector and by extension production levels enter a condition best described as industrial stupor.

So maligned has this once great industry become that coverage of the sector by large investment houses has all but ceased, while much of the remaining interest in the sector is focused on and driven by emotional social posturing.

Yet history has shown that ESG pariahs can provide very profitable outcomes.

Ironically some of the best outcomes come from these types of companies *because* they are precluded from expanding their output and growing their base. Where once companies would take every cent of earnings (and whatever else they could coax from the market) to 'grow', those same companies today have very limited options for capital allocation. Rather than over-reaching and growing, the very case that makes them unattractive (ESG expectations) actually drives a value proposition.

For the first time in many of their history's oil companies are being forced to distribute their excess cash flows rather than 're-invest' them. In doing so, the returns soon to be generated for investors look exceptionally attractive.

Having identified this opportunity, the team from Collins Street Asset Management have launched a new Special Situation Fund to provide investment in this sector on a global level.

The case for oil:

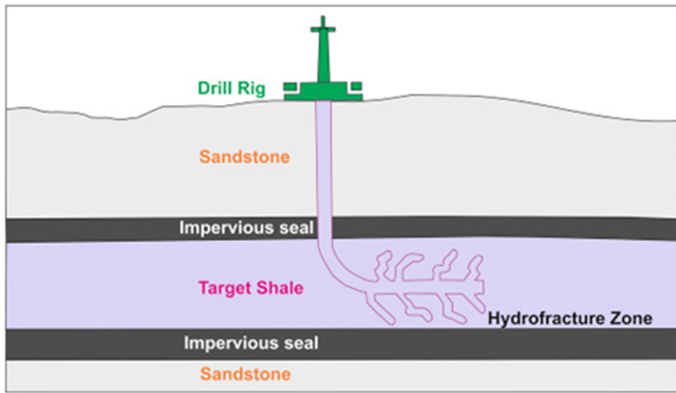
Though the perception of many appears to be that oil demand is driven primarily by the auto industry, that is not actually so. Approximately 15% of oil usage is accounted for by passenger vehicle use, another 15% is spent on air travel, while the bulk of oil usage (70%) is used in plastics and other industrial production.

Even if a case could be made for a rapid increase in take up of electric vehicles for day-to-day travel, many global commodity leaders (including BHP) are suggesting that global demand for oil will continue to increase well into the 2030's.

Additionally, the perceived saviour for the sector and US oil and gas independence – Shale – has proven to be more costly and deplete more quickly than initially anticipated. As an illustration, the average traditional oil reserve depletes at a rate of approximately 10% pa. requiring producers to replace those deposits with new exploration and discovery every ten years or so. Shale reserves have proven to be less sustainable. As opposed to an annual 10% depletion rate, Shale has been shown to deplete at an annual rate of 70% requiring new deposits to be identified every 12-18 months in order to maintain output.

Shale oil rock

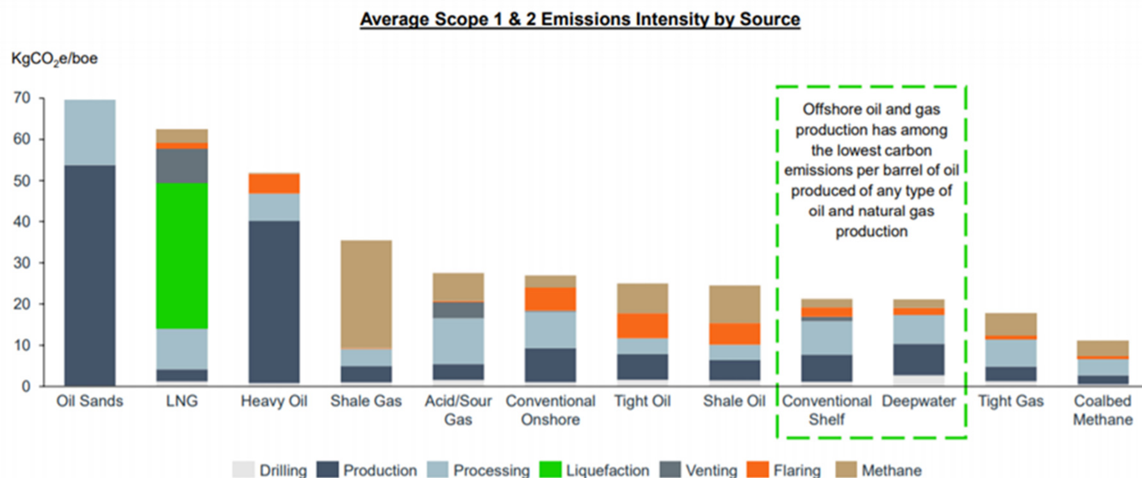
Shale oil mining



What has until now been a slightly more expensive source of energy is quickly becoming a significantly more expensive source as Tier One and Two reserves have been identified and quickly depleted. Pushback from some state and national political leaders in the United States doesn't assist the supply side either.

The case for offshore oil

Though in recent decades considered an afterthought in the oil supply continuum, offshore oil represents approximately 50% of current world reserves. Outside of the Gulf region, offshore oil production is the cheapest source of oil in the world. And, for those of us concerned with the environmental impact of fossil fuel production, offshore oil is amongst the lowest carbon intensive forms of oil production in the world (source: Wood Mackenzie June 2021).



The case for offshore oil service companies

Within the offshore oil space there is a sub-sector that has drawn our attention. Not only do we expect it will benefit from the cyclical turnaround of the oil sector, but our research over a period of months shows conclusively that the global stocks providing exposure to this sub-sector are fundamentally cheap.

Let's explore this in more detail. The offshore oil services space is replete with companies trading on 15-25% of the replacement cost of their assets and are trading on three to five times their cash flows. For the reasons outlined above they have suffered over the years, and recent times has seen a plethora of mergers, takeovers, and in several circumstances the entering and exiting of Chapter 11 bankruptcy. Having undergone such substantial realignment, many companies within the sector have found themselves on the precipice of an industry turnaround, with balance sheets in pristine condition.

Amongst the companies being considered are rig builders, maintenance companies, crew transport and oil transport

In summary, these companies have become low risk, thematically leveraged exposure points to the oil sector recovery, benefiting from both the improvement in oil demand and the closing of the value gap between these companies' improving earnings and their asset backing relative to current share prices.

Due to the high sunk costs of many of these companies, we often find that even a small increase in revenues coupled with slightly increasing day rates/margins can translate into exceptional profit outcomes. One company we have been following recently identified a 12.5% increase in revenue alongside a 160% increase in EBITA.

Conclusion:

We can't be certain how long-term demand for oil will evolve. Nor can we be certain that just because we've identified a dislocation between value and prevailing share prices that the gap will be closed in the short term. What we can be confident of is that given the time, companies with exposure to stable sectors and strong balance sheets are unlikely to trade at such significant discounts to their intrinsic value indefinitely.

If the companies we have identified are able to trade at just 50% of their replacement cost we anticipate a 2-3x return on our investment.

If you'd like to find out more about our close-ended special situation fund, please reach out to Vasilios Piperoglou at Collins St Asset Management (03 9602 1230). Applications for this new fund are limited to wholesale and sophisticated investors only and will close on the 31st of August 2021. Applications can be made via Olivia123.

About the Fund Manager:

The Fund Manager has been running the Collins St Value Fund (CSVF) since 2016. CSVF is a Value investing, long-only Australian equities fund with a mandate to invest in a concentrated portfolio of the manager's favorite ideas.

The Fund has generated an annualised return of 19.33% since inception, has consistently ranked among the top 5 in its category on Morningstar, and is currently Number 1 for 12 months, 3 years, and 5 years on the Morningstar website.

The Fund ranked Number 4 in the 2019 mercer survey of Australian equity mandates, ranked Number 1 in 2020, and ranked Number 2 in the most recent 2021 financial year.

The team are based out of Little Collins St in Melbourne and are available to answer any questions about either of their funds.