Causeway

Reflections on the Crown Jewel: the Saudi Aramco IPO and Changing Global Energy Markets

December 11, 2019

This December, corporate oil goliath Saudi Aramco completed the world's largest Initial Public Offering ("IPO") in history. The company sold a 1.5% stake for $25.6 billion, valuing the largest listed company globally at $1.7 trillion. How will the IPO impact global energy markets and demand for other major oil companies? Causeway fundamental portfolio managers Ellen Lee and Steve Nguyen discuss the outlook for international oil companies in an evolving energy landscape.

Q: Ellen and Steve, why is the Aramco IPO so momentous for the energy sector?

EL: The massive scale and vast financial and crude oil resources of Aramco make it a key player in the global energy market. It is significant that this state-owned oil company, long shrouded in secrecy, will now publicly disclose its financials and operating metrics on a regular basis. Aramco's disclosures as a public company may provide investors insights regarding Saudi's future investment and production plans, which could have ramifications across the global energy supply chain.

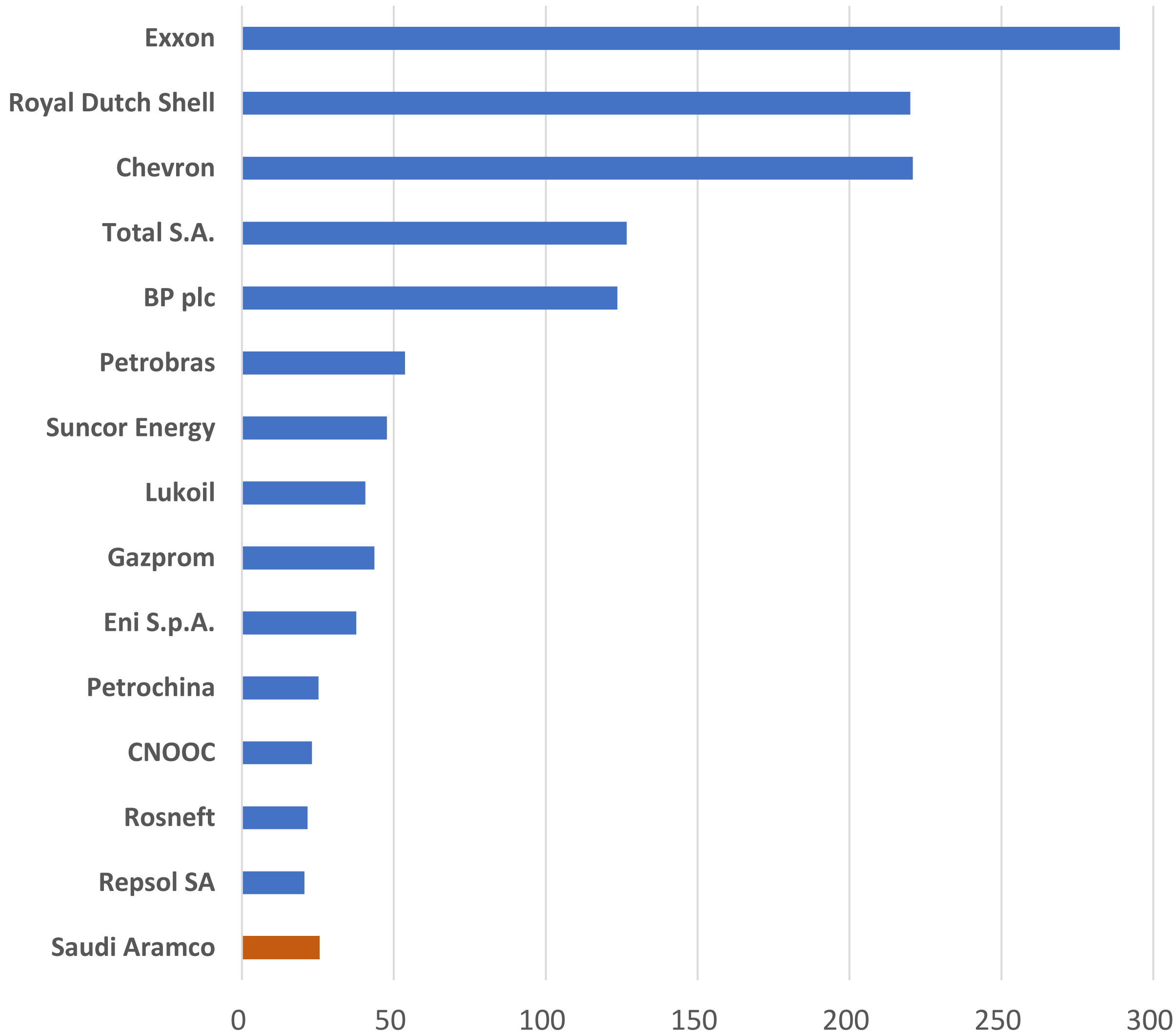
SN: The Aramco IPO also has implications for Saudi Arabia's role within the Organization of Petroleum Exporting Countries ("OPEC"). Saudi Arabia is the dominant force within OPEC, the cartel which controls over a third of the world's oil supply. We currently estimate that Aramco requires an oil price of at least $70 per barrel for free cash flow to cover its dividend and provide room for future dividend growth. From Saudi Arabia's perspective, it may now be that much more critical to support oil prices above $70 per barrel in order to maximize the valuation for future sales of Aramco shares.

Q: Will Aramco attract investor capital away from other energy companies?

EL: Despite its huge scale and competitive advantages, in our view, Saudi Aramco will draw away few investors from the developed world's largest listed energy companies. We believe the degree of share rotation away from other energy companies into Aramco will depend on two main factors: the size of Aramco's publicly traded float and its valuation relative to peers.

SN: Because international appetite for Aramco shares at the proffered valuation was lukewarm, Saudi Arabia slimmed down its share offering and listed the IPO exclusively on its local Tadawul exchange. This initial listing raised $25.6 billion, with a potential for total proceeds to rise to nearly $30 billion if additional shares are sold through a "greenshoe" option. Aramco will not be able to compete directly with global energy peers for capital until the company can list additional shares on an international exchange, which would be after a twelve-month lockup expiring in late 2020 according to Aramco in its Prospectus. Even if Aramco doubled the size of its listed shares to approximately $60 billion, it would comprise less than 5% of the $1.3 trillion public float of the largest private-sector and governmentowned oil companies. As such a small portion of the overall energy equity market, any share rotation into Aramco is unlikely to materially impact the energy majors.

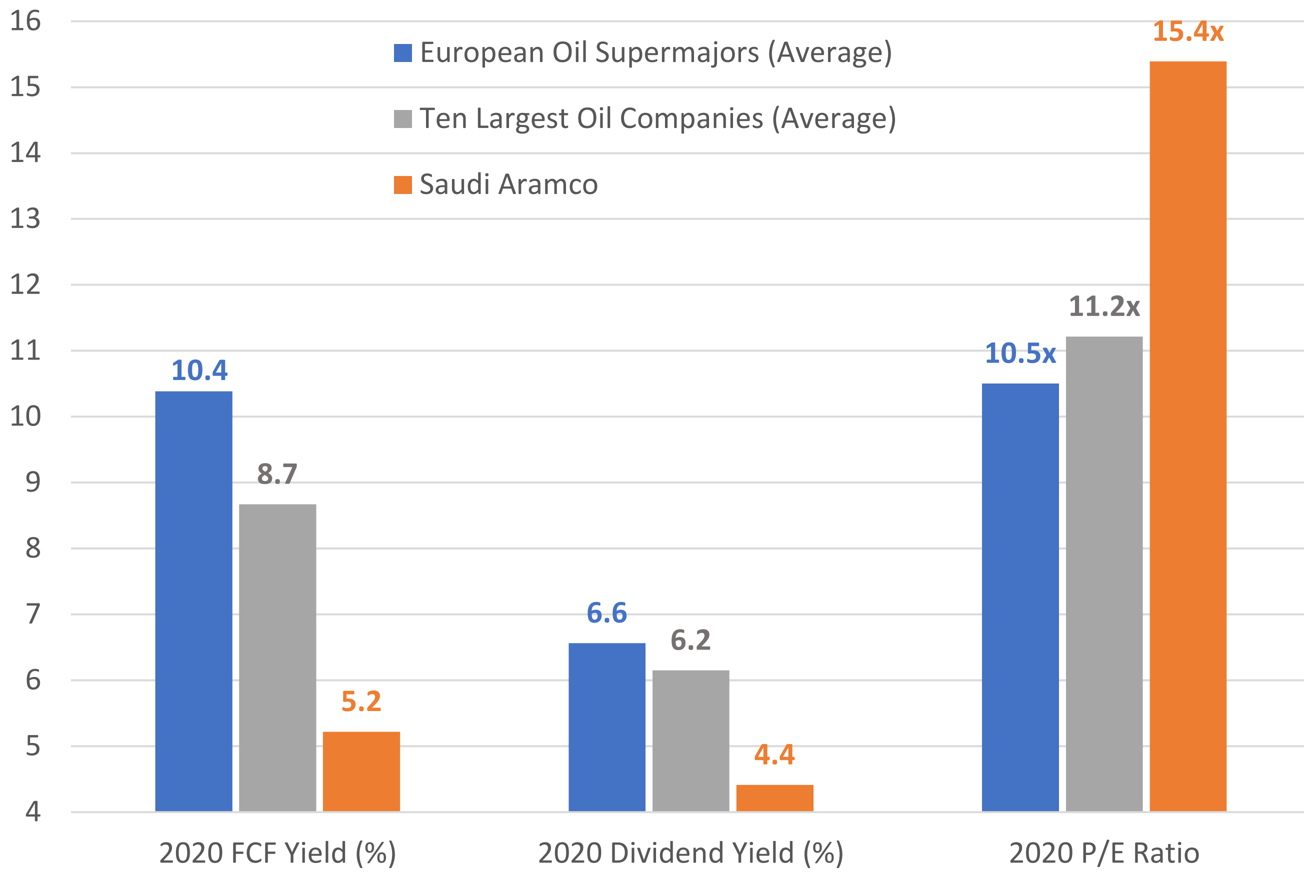
International Oil Company ("IOC") and National Oil Company ("NOC") Free Float, USD billions



Source: FactSet. 15 largest oil companies globally by free float. As of December 3, 2019. Assumes Saudi Aramco sells a 1.5% stake in the company at a $1.7 trillion valuation.

EL: Valuation is another consideration. In a share rotation into Aramco, we believe that the European supermajors—Royal Dutch Shell, Total, and BP—will retain proportionally more investor capital than the other IOCs and NOCs. We believe these European companies offer attractive valuations relative to other large oil & gas companies, including their US peers and Aramco. Relative to the three European supermajors, at the current $1.7 trillion valuation, an Aramco shareholder would pay 30% more for every dollar of their average dividend income, 43% more for every dollar of their average annual earnings, and 47% more for every dollar of their average free cash flow.

European Oil Supermajors Trade at Attractive Valuations



As of December 3, 2019. Source: Causeway; consensus estimates from FactSet, Bernstein. FCF refers to forecast free cash flow, and dividend yield refers to forecast dividend yield. P/E ratio refers to the forecast price-to-earnings ratio. The ten largest oil companies are defined by free float (see prior table), and the European Oil Supermajors are the three European IOCs of the top five "supermajors."

Some of this premium is justified by Aramco's superior profitability and potential downside protection. The oil giant boasts an unrivaled scale of operations. Its access to the largest conventional hydrocarbons reserve base—over 200 billion barrels of proven oil reserves—provides over 50 years of reserve life and allows for some of the lowest lifting and maintenance costs in the industry, as well as unique operational flexibility. But, Aramco is exposed to geopolitical risk, as evidenced by the recent drone attacks that damaged two major Saudi oil facilities. Additionally, while the IOCs are well diversified across fields, regions, and asset mix between oil and gas, Aramco inherently has significant concentration risk in Saudi Arabia as well as to oil. There are two concerns of importance to shareholders: the government's dominant ownership position is not a shareholder-friendly corporate governance structure; and we believe that Aramco is at a suboptimal stage of its capital allocation cycle, as it enters into a multi-year period of elevated spending on lower-return investments in refining, chemicals and natural gas.

With the IPO complete, Aramco is an investment candidate for Causeway's dedicated emerging markets equity portfolios. For these portfolios, Causeway's quantitative researchers will evaluate Aramco's attractiveness along multiple factors, taking into consideration its bottom-up valuation, growth and price momentum characteristics, in combination with top-down assessments of the energy sector and the Saudi Arabian equity market. We also will review Causeway's proprietary corporate governance score for the company.

Q: When evaluating large oil & gas companies from a fundamental perspective, which characteristics does Causeway emphasize?

SN: Most importantly, we look for managements committed to operational restructuring. We believe—and the markets have tended to concur—the best strategy for the oil majors in this environment is one of capital discipline, shareholder distributions, asset portfolio management, and asset diversification. Senior management and boards of directors of oil supermajors we favor have the energy transition in their sights, with goals to balance near-term and long-term objectives. During this transition, some of these companies may outperform as several trade at well-below-market- valuations and offer generous dividend payouts. We hold the supermajors accountable for reaching their goals of generating near-term cash flow and achieving competitive future returns on investments in non-fossil fuel energy.

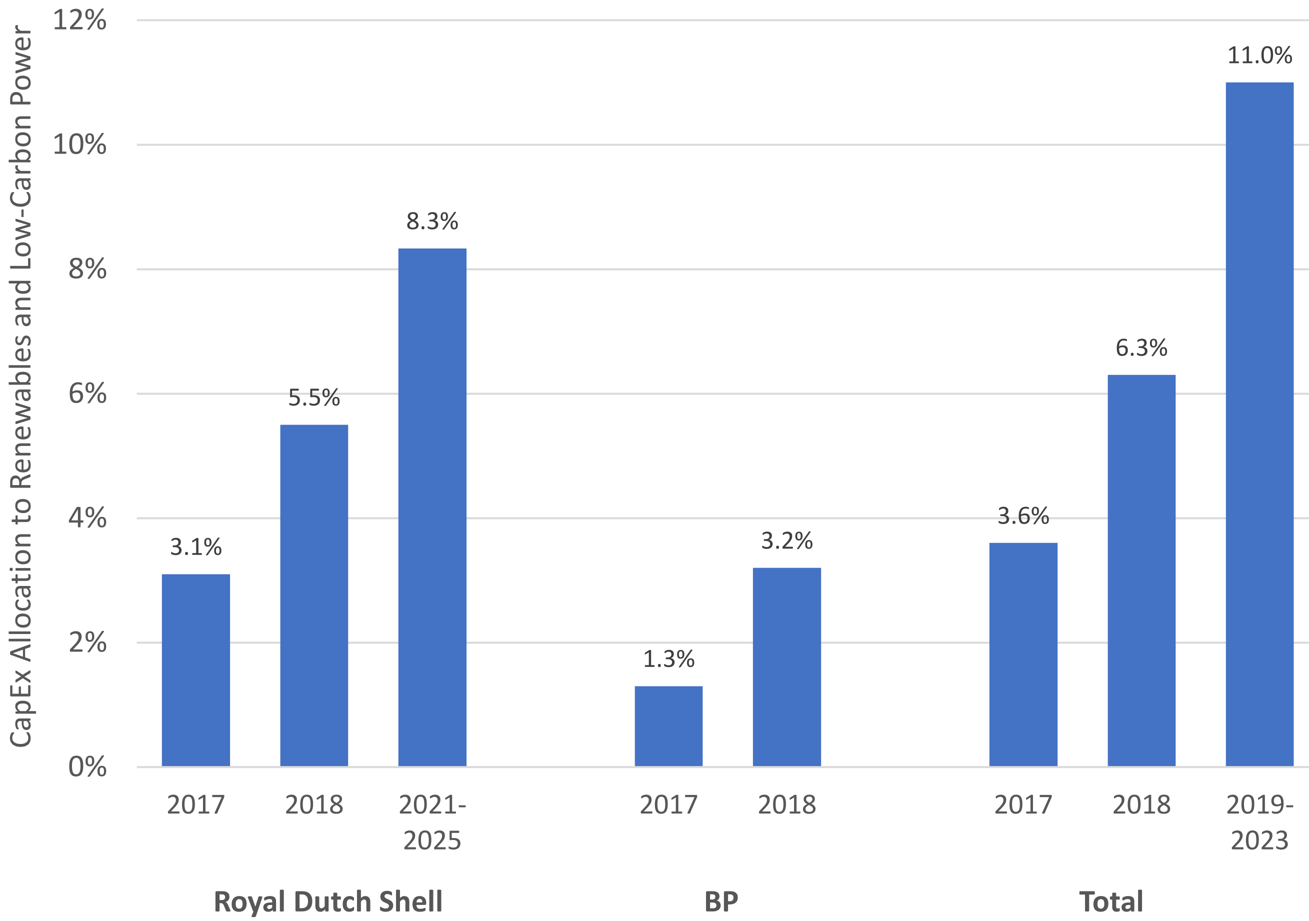
Q: But aren't these declining businesses with huge risk of stranded assets?

SN: Like other cyclical stocks in our client portfolios, we believe current energy company valuations overcompensate for fundamental economic risk. According to our estimates, the European oil supermajors are so low they imply a negative 4.8% perpetual earnings growth rate, discounting sharply contracting crude oil demand. Yes, near-term demand concerns and longer-term pressures from climate change represent headwinds to the oil price, but we believe that heightened geopolitical tensions in the Middle East and the fact that inventory levels remain near historical averages limit further downside.

EL: Our client portfolio holdings in oil & gas supermajors are engaged in production and services related not only to oil, but also to natural gas and renewables. These companies are shifting to natural gas and renewables because of the attractive long-term growth opportunity—and out of necessity. This transition will take years. Even the most draconian oil demand forecasts, envisioning an extremely sharp near-term tightening in climate policies around the globe, expect continued demand growth through the mid-2020s, while more moderate energy transition scenarios forecast continued demand growth through 2040.

The large international energy companies have a history of investing in renewable energy and emissions reductions. The three European oil supermajors invested $2.9 billion in renewables and low-carbon power in 2018, and the annual investments of these companies will likely increase above $5 billion in the next few years. These allocations as a percentage of total annual capital expenditures ("CapEx") currently are 15% or less, but are likely to rise to as much as 25% by the end of the next decade. The areas of investment include biofuels, solar, wind, electric vehicle charging, and electricity. The supermajors also are the largest funders of renewables research at many prestigious universities globally. Company management teams tell us that they are balancing attractive returns for shareholders with the need to transition their portfolios towards a more sustainable mix.

European Oil Supermajors are Investing More in Renewables and Low-Carbon Power



Source: Bernstein, company guidance. Multi-year figures are annualized. BP allocation plans are expected to be disclosed in 2020.

SN: Aramco's IPO has cast a spotlight on its environmental practices. According to Bernstein research estimates, in 2018 Aramco was the third most polluting oil & gas company globally, emitting more carbon dioxide than any of the IOCs, but less than some of the largest NOCs. Although absolute carbon emissions levels are high, it has among the lowest emissions intensity (amount of carbon dioxide released per barrel of oil) of all the IOCs and NOCs. Like many large oil companies, Aramco is investing in a number of green initiatives, including reservoir management, flare minimization, energy efficiency, greenhouse gas emissions management and methane leak detection and repair.

Q: How do you evaluate an oil company's progress in its shift to clean energy and renewables?

SN: We analyze emissions from multiple perspectives: absolute levels, intensity, and trajectory, on a historical basis and relative to company targets and peers. Royal Dutch Shell, Total, and BP each have set explicit greenhouse gas emissions targets that correspond broadly to society's goals to limit global warming by 2050. Additionally, all three companies now link between 20-30% of management's annual bonus explicitly to ESG (environmental, social, and governance) criteria, of which emissions are a component.

EL: We believe that these companies compensate investors, via returns of capital, for the risks inherent in the inevitable energy transition. In an environment where investors are hungry for yield, the European oil majors in our client portfolios provide dividend streams with average yields over 6%. We currently believe these companies can grow their dividends with an oil price as low as $50, and the dividends should be covered by free cash flow even if the oil price declines into the $40s. Higher oil prices, which could come from a settling of the US-China trade dispute or the moderating of production growth in US shale oil, would be beneficial to these companies, but we believe their true value lies in their resilient free cash flows and shareholder payouts.

The enormous size of the Aramco IPO has drawn investor attention to listed oil and gas companies and their future growth prospects. If ever the Saudi Kingdom wanted a stable crude oil price, that time is now. The Saudi crown jewel now trades on the local stock exchange, and may trade internationally in the future. With dual listings and a potential cash haul from future listings, Aramco will likely plough much of that into a clean energy future. These are welcome investments. Stable crude oil prices at current levels and rising natural gas prices will be essential components of the world's transition to renewable energy. And, if oil and gas prices rise, the increase should encourage global investments in technologies that will ultimately supplant the use of fossil fuels. We believe our clients can benefit by owning shareholder-accountable, dividend-paying energy companies which are at the forefront of this critical transition.

Disclosures