Analyzing the Oil-Price Decline and the Search for Value

JULY 2016

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- Causes of low oil-price environment
- Brandes' outlook
- Opportunities for value investors

The oil & gas industry is in the midst of a significant transition as it grapples with one of the most severe downturns in the last 30 years.[1] After higher oil prices drove massive capital expenditures among companies in years past, these companies are now adjusting to a new environment as oil prices have declined to historical lows due largely to a supply glut.

This paper endeavors to answer the questions we have been most frequently asked regarding the current oil-price environment—from what led to the decline in oil prices, to Brandes' outlook—and importantly, the opportunities for value investors.

Whether oil prices will stay on a declining trajectory in the short term remains to be seen. Nonetheless, the impetus for Brandes is to find potentially mispriced opportunities among fundamentally sound companies caught in the maelstrom of a transitioning oil industry.

The current downturn has marked the longest decline in oil prices since at least the early 2000s.

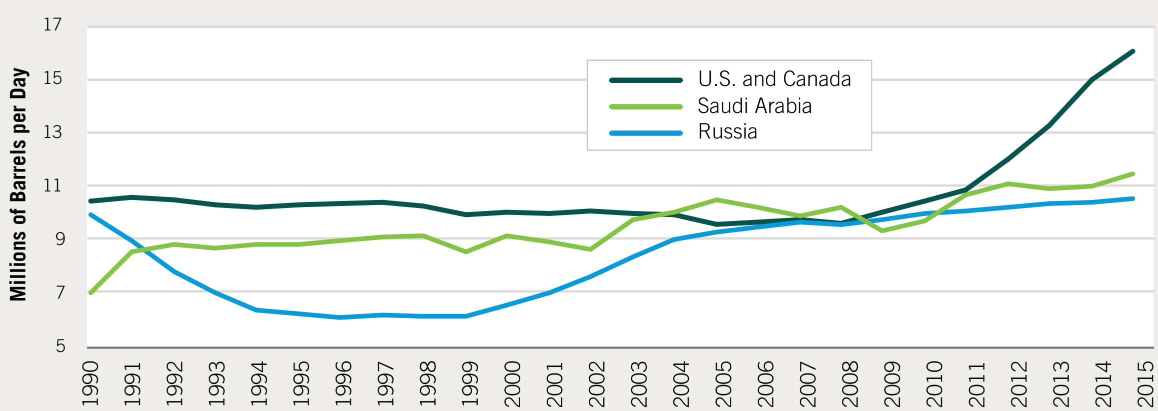
Oil-Price Decline: It's All About Supply and Demand

What caused the steep decline in oil prices?

Oil prices are primarily determined by supply and demand. In a nutshell, the price decline has been a result of a supply-demand imbalance, with oversupply tipping the scale toward lower prices.

As shown in Exhibit 1 on the next page, U.S. and Canada's oil production has nearly doubled over the last several years. Production levels in Saudi Arabia and Russia have increased too, although not nearly at the same pace. This meaningful rise in supply has contributed to falling oil prices.

Exhibit 1: Oil Supply Has Been Increasing, Especially from the United States and Canada
12/31/1990 to 12/31/2015



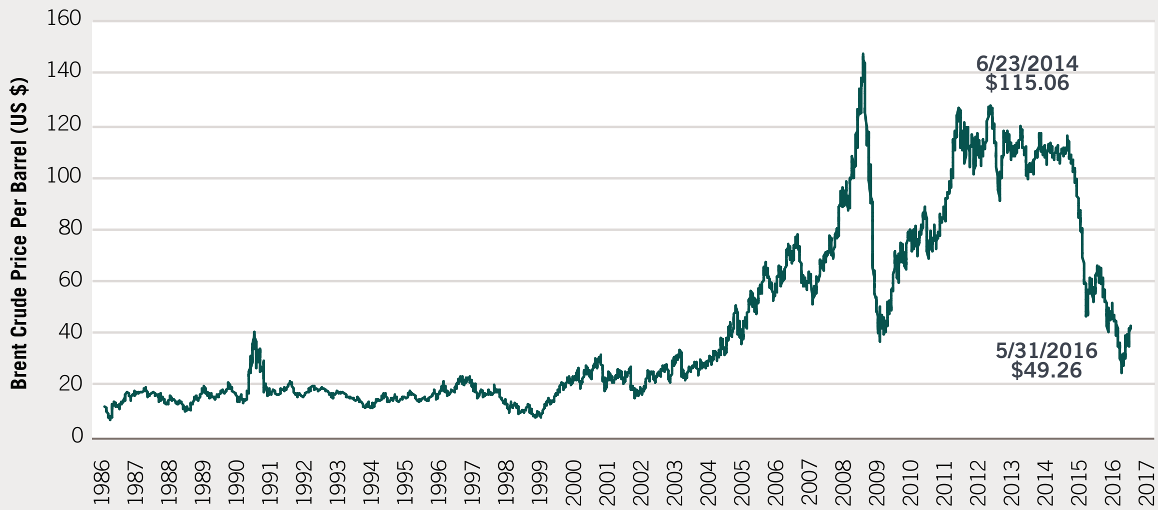
Source: BP Statistical Review of World Energy 2016.

[1]Source: Alix Partners, "Oil & Gas 2016: A Year of Transition," January 2016

Why have prices stayed low for so long?

The current downturn has marked the longest decline in oil prices since at least the early 2000s, as shown in Exhibit 2. In the two years ending May 31, 2016, oil prices fell more than 50%.

Exhibit 2: Oil Prices Have Been on Declining Trajectory for Nearly Two Years
5/31/1986 to 5/31/2016



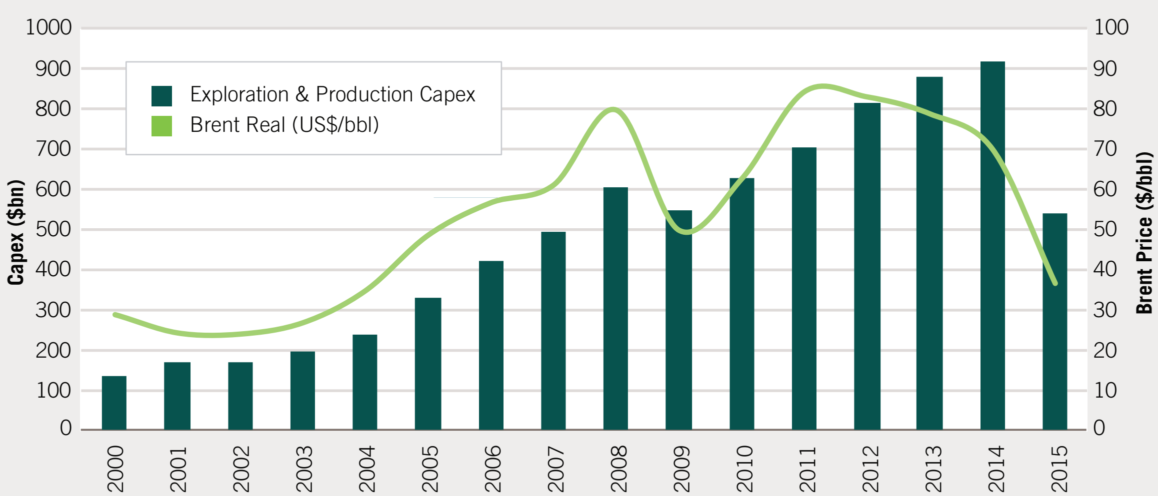
Source: FactSet

One of the main reasons for the sustained low prices, based on our analysis, is oil supply *inelasticity* over the short term, as it takes time for supply to adjust to lower prices.

The "super cycles" in oil prices, periods marked by sustained growth (last recorded from 2002 to 2008 and from 2009 to 2012 as shown in Exhibit 3), led to a huge increase in capital expenditure (capex) in oil exploration and production, which eventually drove the current oversupply. As capital investments by oil companies involve significant fixed costs, their ability to promptly curb production is limited. As a result, producers are likely to continue pumping oil even if doing so generates losses for a period of time.

It is our view that the supply side has played a bigger role in the current downturn than the demand side.

Exhibit 3: Higher Prices Drove Increased Capex
As of 12/31/2015



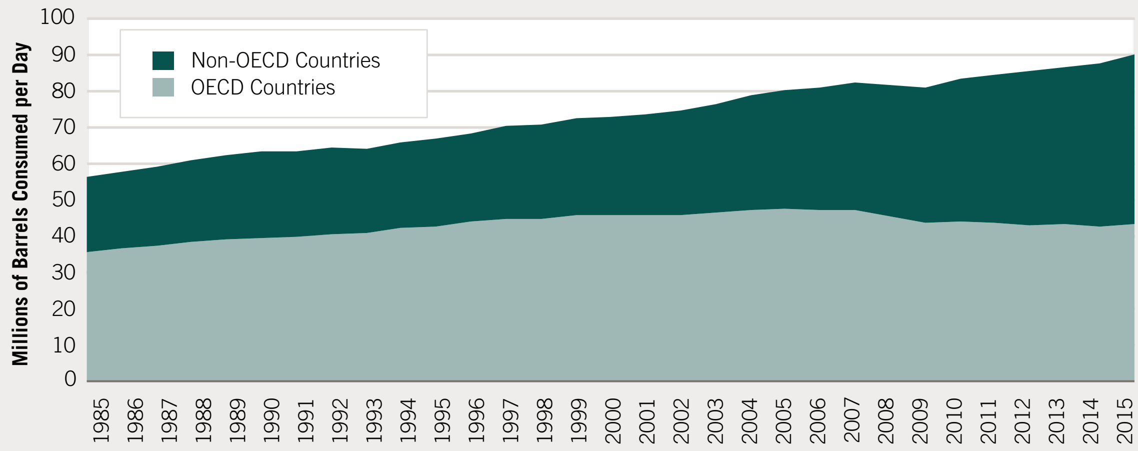
Source: Citigroup, EIA, Bloomberg

What about the demand side? Has it affected prices?

Despite the oil price's boom and bust cycles, demand growth has been fairly constant over the long term. Demand has been growing in emerging markets, represented in Exhibit 4 by non-OECD (Organization for Economic Cooperation and Development) countries, while developed markets (represented by OECD countries) have seen flat demand for some time. As such, it is our view that the supply side has played a bigger role in the current downturn than the demand side.

We believe the price of oil will eventually normalize at its marginal cost.

Exhibit 4: Constant Long-Term Demand Growth, but Evolving Demand Drivers
12/31/1985 to 12/31/2015



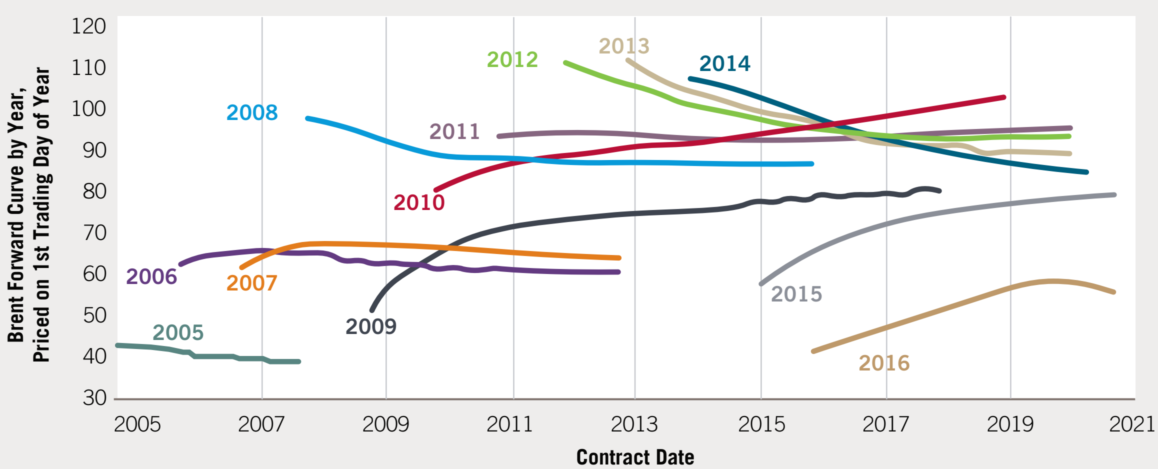
Source: BP Statistical Review of World Energy 2016. OECD: Organisation for Economic Co-operation and Development.

Brandes Outlook on Oil Prices: Up or Down?

Will the low oil prices continue?

Oil prices have actually rebounded from their 15-year low of $26/barrel in early February 2016.[2] Nonetheless, our investment thesis does *not* hinge on predicting short-term price movements, which is a very difficult thing to do. Exhibit 5 shows the challenge of forecasting oil prices.

Exhibit 5: Difficulty in Predicting Oil Price
Brent Oil Price Forward Curve by Year



Source: Morgan Stanley Commodity Research, **March 2016**. There is no assurance that a forecast will be accurate. Because of the many variables involved, an investor should not rely on forecasts without realizing their limitations.

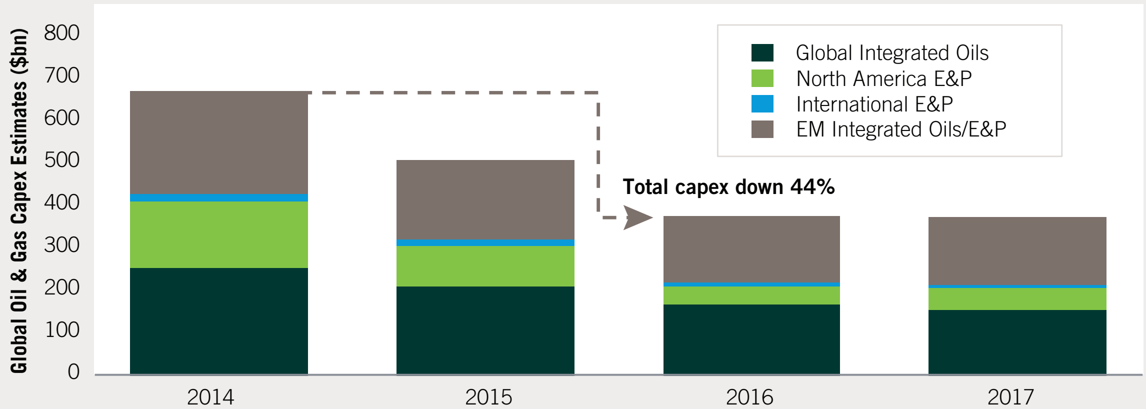
[2]Source: The New York Times, "Oil Price Explained: Signs of Modest Revival," June 2, 2016.

As we take a long-term view of businesses, we also take a long-term view on oil prices. We believe the price of oil will eventually normalize at its marginal cost, which is currently somewhere between $50 to $80/barrel based on our analysis. Note that this is not an exact science; cost curves compress and expand in different economic environments, and as new supply comes online or existing supply goes offline.

The current price environment has already resulted in a significant cut in capex, as shown in Exhibit 6, which could eventually lead to higher prices.

The overall effect of oil-price ups and downs depends on the type of company within the oil supply chain and its cost position.

Exhibit 6: Capex Has Been Cut
(Global Oil & Gas Capex Estimates)



Source: UBS; **As of 12/31/2015**. There is no assurance that a forecast will be accurate. Because of the many variables involved, an investor should not rely on forecasts without realizing their limitations.

What could cause oil prices to stay low even longer?

We believe supply and demand will eventually move back to equilibrium as oil companies lower production spending, eventually leading to inventory declines. As mentioned above, we've seen capex already being cut globally.

The bigger threat that could cause oil prices to stay low even longer, in our opinion, lies with the demand side. As discussed, oil demand in developed markets has been stagnant and overall growth has been driven by emerging markets. If emerging-market demand stalls, potentially due to China's further economic slowdown and its impact on the rest of the world, it may take longer for prices to increase.

However, we still expect to see growing demand from emerging markets considering their rising middle-class population and the subsequent potential increase in oil consumption. Oil demand per capita in China is merely 1/8 of that in the United States (as of January 1, 2014). The number is even lower in India, where oil demand per capita is 1/20 of the U.S. level, suggesting ample potential for growth.[3]

Oil Price and Brandes' Investment Process

How does Brandes incorporate oil prices into its investment process?

In analyzing *any* company, we focus on its fundamentals and valuation drivers. Oil prices naturally play a role in our valuations of oil companies, but the overall effect of oil-price ups and downs depends on the type of company within the oil supply chain and its cost position. For example, an integrated oil company normally reacts differently to changes in oil prices than an oil driller or an oil-services provider. Our primary valuation methodology is based on a normalized return on invested capital, in which one of the variables driving it is our assumption of long-term *normalized* oil price. We then run sensitivity analysis for different oil-price environments and various paths to normalization over three to five years.

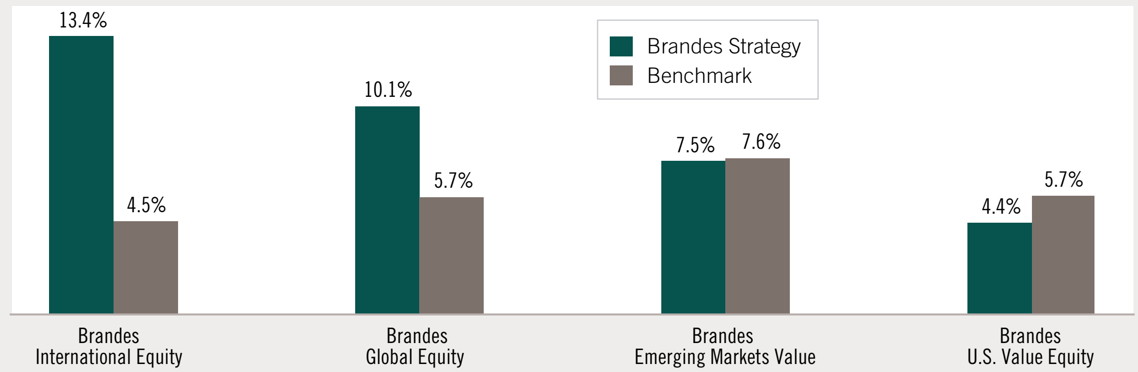
How has this methodology translated into your investment decisions within the energy sector?

In past higher oil-price environments, our oil holdings traded at attractive valuations for a variety of *company-specific reasons*, not due to the price of oil. At the time, we assumed a declining oil-price environment to arrive at what we thought were appropriate long-term normalized return multiples for these companies.

In today's environment, lower oil prices seem to have indiscriminately pushed down the stock prices of many oil & gas companies—regardless of their potential. In contrast to the view we took during higher-priced periods, we now assume increasing oil prices in determining the normalized returns on invested capital for the companies we analyze. Exhibit 7 shows our positions in the oil & gas industry in some of our strategies. Note that our investment decisions result from a value focused, bottom-up approach—unaffected by benchmark weightings.

[3]Source: IndexMundi—Country comparison: Oil consumption per capita: http://www.indexmundi.com/g/r.aspx?v=91000

Exhibit 7: Brandes Oil & Gas Weighting vs. Benchmark
As of 3/31/2016



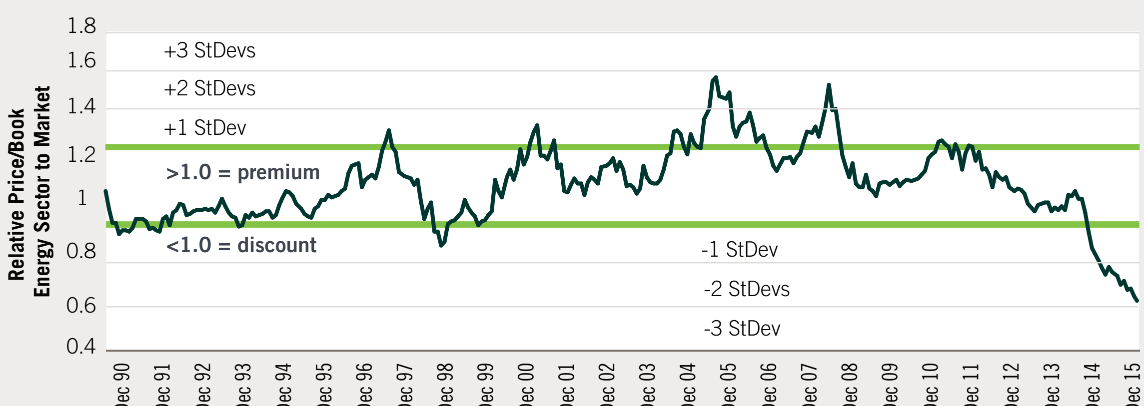
Source: Brandes, MSCI., S&P as of 3/31/2016. The portfolio characteristics shown above each relate to a single account as of date noted, deemed by Brandes to be generally representative of the strategy. Not every account will have these exact characteristics. The actual characteristics with respect to any particular account will vary based on a number of factors including but not limited to: (i) the size of the account; (ii) investment restrictions applicable to the account, if any; and (iii) market exigencies at the time of investment. Data is updated on a quarterly basis. Brandes International Equity is benchmarked against the MSCI EAFE Index, Brandes Global Equity is benchmarked against the MSCI World Index, Brandes Emerging Markets Value is benchmarked against the MSCI EM Index and Brandes U.S. Value Equity is benchmarked against the S&P 500 Index.

Value Opportunities Among Oil Companies

How attractive is the energy sector?

As shown in Exhibit 8, the whole energy sector currently looks appealing based on its price-to-book ratio. Despite this overall attractiveness, it is important, in our opinion, to look at the companies individually. We do this by making our investment decisions based on each company's fundamentals, including its competitive positions and its likelihood to be a going-concern business. Note that this is something quantitative or passive investment strategies may not do.

Exhibit 8: Energy Sector Shows Historic Low Valuations
12/31/1990 to 12/31/2015



Source: Factset as of 12/31/2015. Bloomberg, CapitalIQ, Worldscope via FactSet. Market defined as the top 25% of companies in the world including emerging markets based on market cap, after exclusion of securities with free float market cap <US$100 million. As of 12/31/2015, this generally included all companies with market caps in excess of US$500 million. Past performance is not a guarantee of future results.

Currently, we see most value potential in large-cap integrated oil companies primarily based in select European and emerging-market countries.

Where is Brandes finding the best value potential? Why?

The oil industry can be broken up by each company's position in the supply chain (exploration & production or E&P, drilling, services, storage & transport, and refining) and integrated oil companies operate across the entire supply chain.

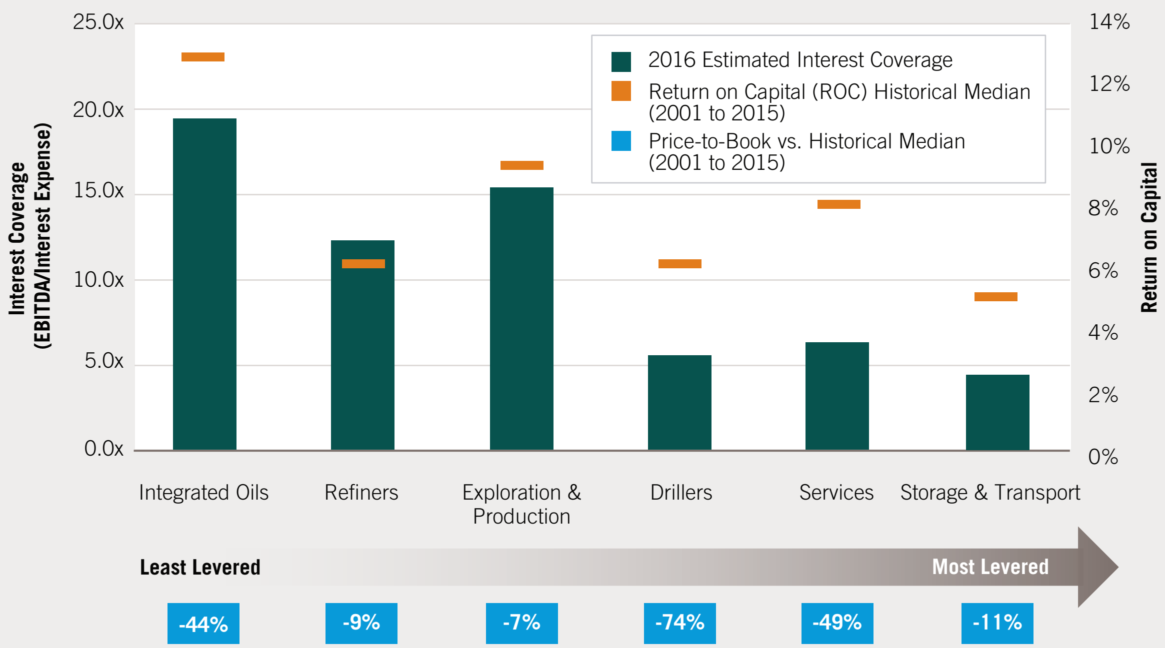
Currently, we see most value potential in large-cap integrated oil companies primarily based in select European and emerging-market countries. In our view, the diversity of integrated oils' operations may help reduce their overall sensitivity to the changes in oil prices. Moreover, even though each company is unique, some shared characteristics that make us attracted to these companies, as shown in Exhibit 9 on the next page, include:

- Solid balance sheets that were less leveraged than pure-play players; one proof-point is that large-cap integrated oil companies have relatively strong estimated 2016 interest coverage
- Strong history of returns on capital, with a median of 13% vs. less than 10% for the rest of the sector
- Attractive valuations, including a price-to-book ratio that was over 40% lower than its historical median as of March 31

These factors have led us to believe that these integrated oil companies are better equipped to navigate the current downturn than the majority of their pure-play counterparts (e.g., refiners, drillers).

An example of a company which we are finding value in is one of our Russian integrated oil holdings.

Exhibit 9: Integrated Oils Are Less Leveraged, Have Strong History of ROC and Attractive Valuations (As of 3/31/2016)



Source: CapitalIQ as of 3/31/2016. Median of 10 largest companies within each industry by Enterprise Value (Market Cap + Net Debt).

Interest coverage: Earnings before interest, taxes, depreciation and amortization/Interest expense. Sorted from left to right based on leverage as measured by debt/equity ratio.

There is no assurance that a forecast will be accurate. Because of the many variables involved, an investor should not rely on forecasts without realizing their limitations. Past performance is not a reliable indicator of future results.

Can you provide examples of such companies in your portfolios?

An example of a company which we are finding value in is one of our Russian integrated oil holdings. The company is a more defensive business in a declining oil-price environment. It has a healthy oil reserve life of 21 years, nearly double the global average. Its historical profitability per barrel of oil has also been quite stable and less volatile than the oil market price, thanks partly to Russia's progressive tax structure on the oil industry. Furthermore, much of the company's revenue is generated in U.S. dollars, with a portion of its costs denominated in rubles. As a result, the weakening of the ruble has had a positive net impact on the company's profitability. In addition, the company has a strong balance sheet with an interest coverage ratio (measured by EBITDA divided by interest expense) of 19x and a debt/capital ratio of 21%, which is less than the median integrated oil company at 29% (this is significantly less than pure-plays in the other part of the value chain where the median varies from 35% to 60%).[4]

We find the company's valuation very appealing and believe the stock offers an attractive risk/reward opportunity given the market's seemingly extreme pessimism around both Russian and oil stocks.

Another example is one of our European integrated oil holdings. The company has generated strong historical returns on capital (20% for its 10-year average upstream business [or E&P], above its peers which have been in the mid-teens), while also seeing its exploration efforts lead to better reserve replacement growth (135%) than peers. The company has an attractive growth profile, good balance sheet, and low-cost operating position. However, it currently trades at less than tangible book value and we are finding a significant margin of safety in the shares.[5]

Many integrated oil companies pay dividends. How sustainable are these dividends?

Many integrated oils will likely be able to continue to pay their dividends as they cut back on capex. However, we do not invest in a company solely on the basis of dividend yields. Moreover, it is important to analyze company balance sheets and historical cash flow to judge the sustainability of dividends.

Some energy companies have already cut dividends, while others may follow suit. Even so, we believe integrated oil companies' ability to pay out dividends is still better than many pure-play companies, which have cut or even eliminated dividends as they try to preserve cash in the downturn.

What about other types of companies in the sector, including energy-related master limited partnerships (MLPs) that have been in the news a lot lately?

From a valuation perspective, refiners only trade at a slight discount to their history. This is also true for storage & transport companies (mostly structured as MLPs), which had benefited from investors reaching for yield, driving their valuations up to what we considered quite expensive levels over the past five years.

We've found drillers and E&P companies that seemed to be priced very cheaply on the surface. However, further reviews revealed that many of these companies have highly leveraged balance sheets, which may inhibit their ability to survive the downturn.

Finally, while many oil-services providers look attractive on a valuation and balance sheet basis, they have benefited significantly from the oil super cycle, which resulted in above-normal demand for their services. This likely will lead to a protracted downturn in demand as the entire sector cuts spending.

As the oil & gas industry shifts from boom and bust cycles, it is important, in our view, to focus on company valuations in relation to their fundamentals.

[4]Source: Capital IQ as of 3/31/2016. EBITDA: Earnings before interest, taxes, depreciation and amortization.
[5]Margin of safety: The discount of a security's market price to what the firm believes is the intrinsic value of that security.

Conclusion: Boom or Bust, Focus on Company Valuations Is Paramount

As the oil & gas industry shifts from boom and bust cycles, it is important, in our view, to focus on company valuations in relation to their fundamentals. We are confident that our Graham-and-Dodd value investing approach, combined with our ability to be patient, enables us to uncover fundamentally sound companies suffering from mispricing, such as those in integrated oils, where we have observed the greatest value opportunities recently.

We believe this focus is the best way we can pursue the desired long-term results for client portfolios.

Tangible book value: Book value minus intangible assets (e.g., goodwill).

Brandes International Equity benchmark: The MSCI EAFE (Europe, Australasia, Far East) Index with net dividends measures equity market performance of developed markets in Europe, Australasia, and the Far East.

Brandes Emerging Markets Equity benchmark: The MSCI Emerging Markets Index with gross dividends measures equity market performance of emerging markets. Brandes European Equity benchmark: The MSCI Europe Index with net dividends measures equity market performance of developed markets in Europe. Brandes U.S. Value Equity benchmark: The S&P 500 Index with gross dividends measures equity performance of 500 leading companies in industries of the U.S. economy.Brandes International Small Cap Equity benchmark: The S&P Developed Ex-U.S. SmallCap Index with gross dividends measures the equity performance of smallcapitalization companies from developed markets excluding the United States. Brandes Global Equity benchmark: The MSCI World Index with net dividends measures equity market performance of developed markets. MSCI has not approved, reviewed or produced this report, makes no express or implied warranties or representations and is not liable whatsoever for any data in the report. You may not redistribute the MSCI data or use it as a basis for other indices or investment products.

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