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# Navigating the oil fields

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## Key highlights

- The drop in oil prices during 2014 resulted from a convergence of global supply and demand factors.
- While the effects of the price drop in producers is widespread, research reveals differences in impact within the sector.
- A period of low prices favors producers with high-quality shale deposits.
- We believe that oil prices will continue to be driven by innovative production methods.

**With low oil prices entrenched in the investment landscape, we believe it's important to understand short-term risks and the long-term opportunities driven by energy sector innovation.**

### The 2014 price shock

The surge in North American oil production over the past several years has tipped the balance of supply and demand in the near term, and provides a range of investment opportunities in the long term.

Oil prices have plunged by 50% with global markets becoming oversupplied, driven by new output from North America. The United States has emerged as one of the world's largest oil producers along with Saudi Arabia and Russia.

**Figure 1. Oil fell to its lowest price in over five years**



Source: U.S. Energy Information Administration, Cushing, OK WTI Spot Price FOB (dollars per barrel).

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## Excess supply weighs on near-term prices

The plunge in oil prices is driven by four key factors, in our view:

- Weakening demand from an economic slowdown across Europe and China
- Increased supply due to the surge in production from North American shale reserves
- A strengthening dollar, which continues to create a deflationary pricing environment for all commodities
- Saudi Arabia's decision not to cut back on production

With oil prices having fallen by approximately half, some industry-watchers speculate that North American producers, which operate with relatively higher production costs than many global competitors, will be squeezed out of the market. The result would be a significant downturn in activity.

Despite the oil price drop, we believe the renaissance of the North American energy industry continues to be a key investment theme. Companies with high-quality

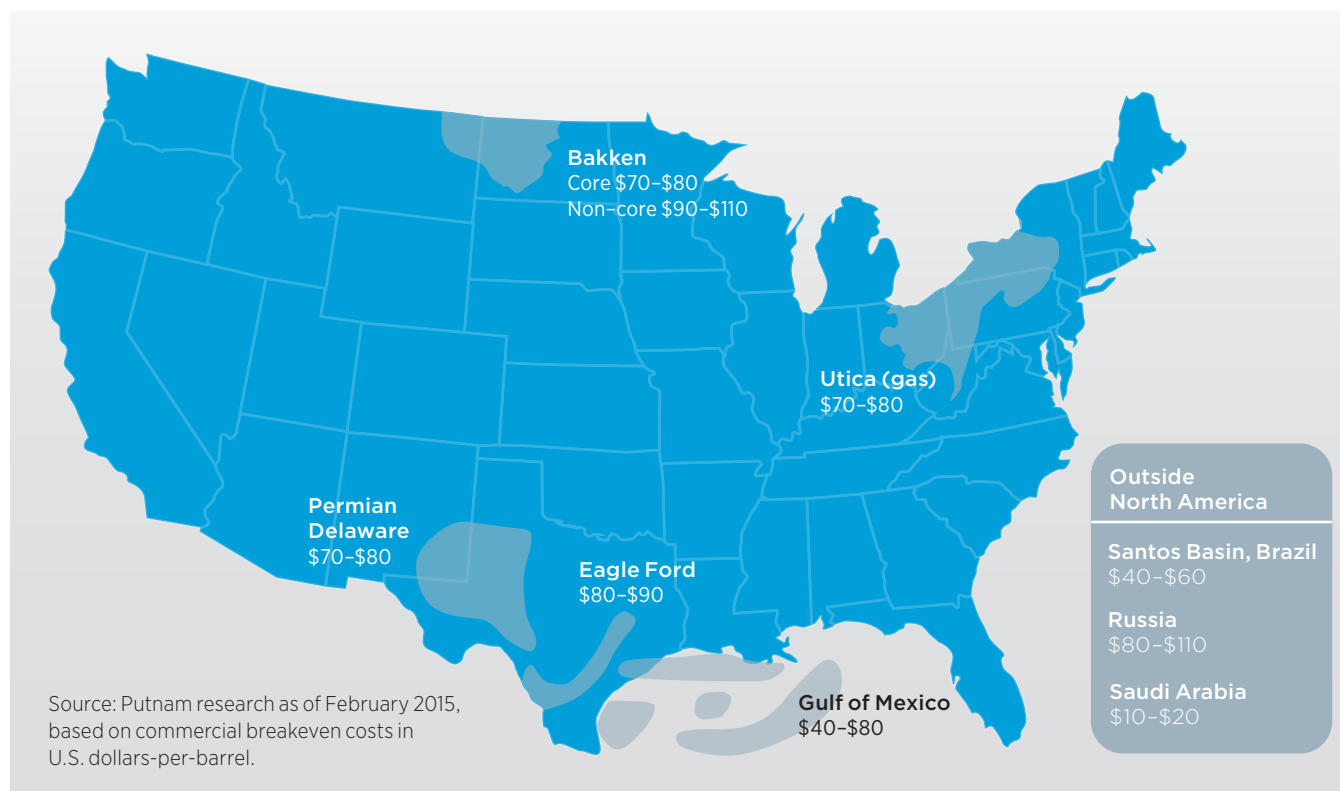
shale deposits, and equipment and services companies supplying larger oil producers, appear well positioned to navigate this dynamic environment, in our view.

We believe it is shortsighted to count out North American producers, for two key reasons.

First, oil companies developing petroleum and natural gas resources in the United States and Canada have continued to experiment with new techniques to drill, and to complete the construction of wells. This progress has increased the amount of oil recovered per well, resulting in enhanced efficiency and lower breakeven costs.

Second, shale production has the flexibility to respond to short-term price movements. It is the only supply source that can be increased or decreased in relatively small quantities with minimal lead times. Whereas large deepwater projects demand multiyear capital commitments, shale investments can be dialed up or down as the oil markets necessitate. Under current supply conditions, shale investments will likely be scaled back in the near term. However, looking further down the road, to

**Figure 2. Breakeven prices (dollars per barrel) in many North American oil fields and shale deposits are above recent global prices**



the second half of 2016 and beyond, companies are likely to increase shale investments, we believe, while deferring larger capital projects, precisely because of the flexibility offered by shale production.

### Sifting the rubble: prospects for the energy services industry

Larger production rates and better returns for oil companies in the five years before 2014 increased the spending directed toward the oil services industry in recent years. Our conversations with U.S. oil producers and service companies helped us to identify and confirm this trend as it emerged.

The current slowdown in U.S. shale investment has had a major and widespread impact on general services companies. There are scant prospects for near-term recovery, but we do see a differentiation in opportunities over time.

Providers of goods and services critical to improving the economics of onshore producing wells are likely to benefit when demand rebounds.

Given the capital spending trends that we have seen, service providers focused on large offshore projects are likely to face longer-term headwinds. We have a negative outlook for offshore drillers and companies that provide engineering and installation services for these projects.

### High-yield debt linked to the energy complex faces challenges

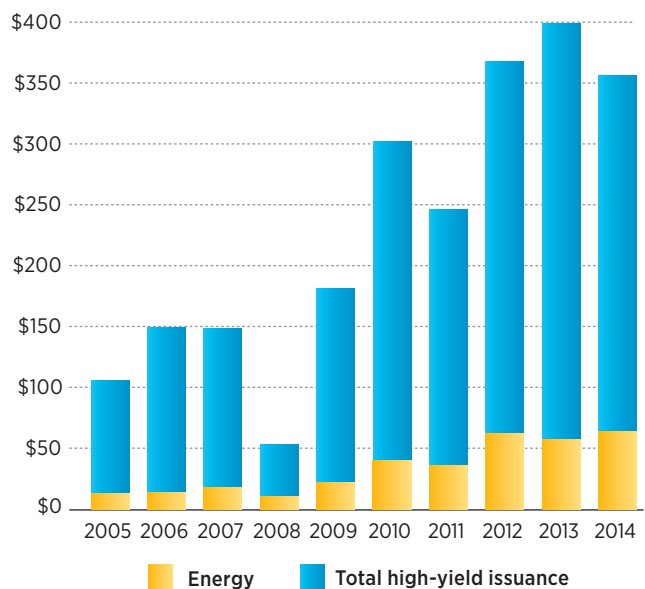
The fall in the price of oil is also having an effect on the high-yield bond market.

Many North American energy companies have borrowed significantly in the public debt markets to finance their operations. Extracting and moving oil and gas is capital-intensive, so this debt is necessary for exploration and production (E&P) companies and transportation companies, in particular. *The Wall Street Journal* reports that U.S. oil and gas companies have increased their borrowing by 55% since 2010, to an amount approaching \$200 billion.

As the price of oil has fallen, the economics have changed for these companies. At current price levels, profit margins are squeezed. Therefore, many of the high-yield bonds in this space have lost value in recent months.

Energy-related debt makes up approximately 15% of the U.S. high-yield bond market and less than 10% of the global market. While representing a large portion of the market, the differences among issuers within the sector need to be recognized.

**Figure 3. Energy debt has grown as a share of total high-yield issuance**



Source: JP Morgan, *High Yield Market Monitor*, February 2, 2015.  
Data shown in billions.

First, the type of company can vary. There are E&P companies that extract energy from the ground, service companies that support the E&P companies, and transport companies, such as pipelines, that move the product. Of these, E&P companies face the most direct consequences of the price drop. In turn, service companies, especially those that support producers with weak profiles, also experience an impact. However, transport companies see much less of the effect, since energy must still be moved from producers to consumers.

Secondly, within these segments there are better-run and less-levered companies that should be more resilient than highly levered companies with less liquidity.

We take these differences into account in assessing risk in the sector. Should oil prices recover over the next year, we would not expect to see high levels of defaults. A reason for this is that many companies have hedged their near-term production to lock in higher prices into

the future. However, if oil prices remain at or below \$50 for a prolonged period of a few years, an uptick in default risk becomes more likely, though the risk would probably remain manageable in the context of historical default levels. We continue to monitor the situation closely.

### **Low oil prices prime the pump for the future**

This historic change in oil prices has significant near-term effects, but as investors, we are more focused on the long-term consequences.

First, since oil prices can move more quickly than the pace of production, there will be excess supply in global markets for the foreseeable future. It will take time to correct the glut, which is likely to keep prices near the levels where they hover in early 2015.

Since investment in U.S. shale production can react relatively quickly, it has already slowed in response to

falling prices, and the resulting pain has been felt across all types of services companies, even those that improve the economics of producing wells.

In the longer run, a new dynamic is at play, one that makes the oil market more like other commodities: The price of oil will find a ceiling near the marginal cost of production. This marginal cost is now being set by the progress of innovation in North America.

While oil prices remain low, we believe many stocks of high-quality companies in the energy sector offer attractive investment opportunities. We favor companies that have high-quality energy deposits to extract and strong capital funding on their balance sheets. Many of these firms are in North American markets, but there are also compelling opportunities around the world.

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