Do These Oil Companies Have 50% Downside?

Description

Last week, **Morgan Stanley** warned that many oil and gas companies may have up to 50% more downside left, even as oil prices start to stabilize. Specifically, it cut its ratings for **Marathon Oil Corporation**, **Encana Corporation**, **Canadian Natural Resources Limited**, and **Whiting Petroleum Corp**.

While most producers continue to cut corporate costs and slash capital expenditures to adjust to a lower pricing environment, the future of most firms relies on higher oil prices. That's why Morgan Stanley's downgrades stemmed from their weaker outlook for commodity prices.

The company's analysts referenced the "resiliency of global production especially U.S. shale, the potential return of Iran and Libya to the market, and the softening of demand have pushed the timing of the expected balancing in the crude market into 2017." While Morgan Stanley's expected oil to reach $80-85 a barrel by 2018, its forecast is now reduced to just $57-60.

If Morgan Stanley's dire forecast comes to pass, perhaps there would be massive downside left to go for most oil companies. Not only would selling prices be pressured, but outsized debt loads for many smaller producers may force some to become insolvent. What are the chances that oil takes until 2018 to reach $60 a barrel?

Most companies can't survive with current prices

Thomson Reuters Corp. estimates that "around 50 listed U.S. independent oil producers and scores of smaller ones need $40-60 a barrel to break even." Continued $30 oil will confront them with stark choices: bankruptcy, debt write-downs in return for deep concessions to creditors, or fire sales of assets at a time when potential buyers are skittish.

With oil under $32 a barrel, it's tough to see current prices remaining past 2016. As such, the U.S. Energy Information Agency (a well-respected agency with historically conservative estimates) expects higher prices over the next 12-18 months. Its short-term energy outlook released on January 12 forecasts that Brent crude oil prices will average $40 per barrel in 2016 and $50 a barrel in 2017. The forecast expects the oil glut to be absorbed sometime next year, implying that prices may find stability at these higher prices.

Oil supply will stabilize, but at what price?

Based on breakeven prices for most producers, higher oil forecasts make sense. Looking at data from **Baker Hughes Incorporated**, the global oil rig count has dropped dramatically since oil started to slide. Total world-wide rig counts have fallen by roughly 50% from their peak with nearly every global producer looking to slash costs even further over the next 12-24 months to maintain financial stability. Leading the way in rig-count reductions is the U.S., which is responsible for over 50% of the global decline.

Still, oil prices may take some time to reach historical levels. OPEC, for instance, doesn't see oil prices returning to triple-digit territory within the next 25 years. It does, however, expect oil prices to rise by an average of about $5 per year, reaching $80 per barrel by 2020.

While oil prices should eventually rebound, it may be a slower climb than most anticipate. If you want to bottom pick the industry, make sure you stay with well-financed operators such as **Exxon Mobil Corporation** (NYSE:XOM) or **Occidental Petroleum Corporation** (NYSE:OXY).

Investments in smaller companies with higher leverage metrics may turn sour because their finances are incapable of surviving the slow, multi-year rebound in energy prices.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:OXY (Occidental Petroleum Corporation)
2. NYSE:XOM (Exxon Mobil Corporation)

Category

1. Energy Stocks
2. Investing

Date
2025/06/30
Date Created
2016/01/28
Author
rvanzo