The Rout of Oil Stocks Is Far From Over

Description

As far back as 2018, analysts were predicting another oil price collapse would occur in 2020. That moment has arrived with the international benchmark Brent price losing 46% for the year to date to be trading at US$35 per barrel. This triggered a sharp sell-off of energy stocks as investors stampeded for the exits. As a result, the largest industry ETF, the **SPDR S&P Oil & Gas Exploration & Production ETF**, has lost 65% for the year to date with signs of further losses ahead.

A new price war

It isn't only the coronavirus that is responsible for the fear. A price war has erupted between Saudi Arabia and Russia after the disintegration of the production cuts deal that, since 2016, has supported higher oil. This occurred in an environment where there was an existing supply glut where higher prices were essentially the result of the production cuts agreed by OPEC and its allies, notably Russia, rather than a material change in supply and demand. The collapse of the deal saw Riyadh not only vow to boost its oil output by up to 28% to 12.5 million barrels daily but also slash oil prices to gain market share. Moscow responded by claiming it could lift oil output by up to 500,000 barrels daily. This sent prices into a tailspin, and there are signs it will take time for them to recover.

There are claims by some industry insiders, such as **Continental Oil** founder Harold Hamm, that the latest moves by Riyadh and Moscow constitute an attack on U.S. shale. This is because U.S. shale oil is far more price sensitive than Russian or Saudi production. This, however, may not be the case, because U.S. shale proved far more resilient than anticipated during the last oil price collapse, when Brent fell below US$30 per barrel. Despite sharply weaker oil, the industry was responsible for the substantial production growth that saw the U.S. overtake Saudi Arabia to become the world's largest oil producer in late 2018.

Poor outlook

What is becoming clear is that it will take some time for the re-balancing of the oil market to occur, meaning there are further losses ahead for energy stocks. Attempts to control the coronavirus pandemic are significantly reducing economic activity, meaning that demand won't increase, even as oil prices fall. There is substantial uncertainty as to what the impact of the virus will be, despite moves by central banks to stimulate economic growth, and when the economy will finally rebound.

However, global oil production and inventories will keep climbing because of the price war. That will apply considerable pressure to oil and create a highly uncertain operating environment for upstream oil producers. Many oil companies are slashing spending and cutting dividends to shore up their cash flow and balance sheets. Globally diversified upstream oil producer **Vermilion** (TSX:VET)(NYSE:VET) cut its supposedly safe dividend in half to $0.115 per share.

That — along with significantly weaker oil and growing anxiety over the fallout from the coronavirus — has caused Vermilion stock to plunge by 80% since the start of 2020. Even after management took a knife to Vermilion's dividend, it still has a monster 34% yield because its stock has crashed to record lows. For these reasons, there could be additional cuts ahead, and Vermilion may even elect to cease paying dividends until greater certainty regarding the economy and oil prices emerges.

While recent events have triggered considerable alarm regarding the fate of upstream oil producers, Vermilion can survive the latest price collapse. It reported record oil reserves, production, and cash flow for 2019 in what was a challenging operating environment where Brent averaged US$64 per barrel. It finished 2019 with a solid balance sheet. This was illustrated by Vermilion's debt being a modest two times 2019 EBITDA and an interest coverage ratio of 13.5. It also has $2.5 billion of credit capacity, endowing Vermilion with considerable financial flexibility.

Looking ahead

The outlook for crude remains poor for the foreseeable future. There is considerable uncertainty surrounding the economic fallout from the coronavirus pandemic. This — along with the latest price war between Riyadh and Moscow — means that a rebound is a long way off. That will weigh heavily on oil stocks over coming months.

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