

Is it Time to Buy Oil Stocks?

SPECIAL REPORT

June 2016



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Before we can think about oil producers we need to think about oil. Is the nascent oil price recovery sustainable?

Is it time to buy oil stocks?

Part 1

Oil prices have recovered from a calamitous fall earlier this year. From lows of US\$26, prices have jumped to around US\$50 a barrel and, while they remain at half their highs, the rise has been enough to pique the interest of investors. Oil is no longer a dirty word.

Key Points

- ***Oil is on the radar***
- ***Shale industry is imploding***
- ***Higher prices should be sustained***

There were good reasons to shun oil stocks at lower prices. Producers carried high levels of debt, cash flow was falling and asset values plunged. Producers faced the prospect not merely of lower profits but of possible death. The existential threat is now mostly gone and, in some cases, balance sheets have been strengthened.

After indulging in ambition and vanity for so long, producers have returned to restraint by cutting capital expenditure, slashing costs and, finally, starting to pull back production. This is a promising first sign that the oil price crash may finally be over.

We've argued for a while that prices should return to US\$70–80 a barrel over time (see [*What now for the oil price?*](#)), where we believe marginal production costs will bring supply and demand into balance. It's taking a while for that to happen because producers have been quick to cut costs and slow to cut output.

At the start of this year, despite oil prices being down more than 70% from their peak, global oil output had declined by less than 1%. It was a key reason why prices got as low as they did and stayed there for as long as they did.

That is now changing. Hedges, which shielded many producers from the worst of the decline, are running off; cash flow is drying up; and debt is being called in. More than US\$2 trillion has been wiped from the value of energy producers globally as investors anticipate the inevitable: as the health of producers declines, production is starting to follow. For the first time in years, an oil price recovery

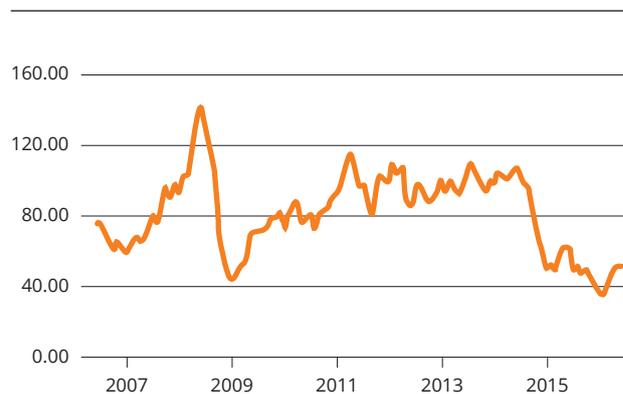
is in sight, largely because of an expected decline in US shale output.

Where it all started

OPEC gets blamed for oil price crashes, with Saudi Arabia often condemned for flooding the market with supply. Since so many see OPEC as the source of the problem, they think the solution – lower output – must also come from there.

Yet those looking to OPEC to restore supply discipline are looking the wrong way. OPEC includes the lowest-cost producers in the industry. Their profits are lower because of lower prices but their existence isn't threatened. If acting rationally, there is no reason for OPEC to cut output. No, it was US shale that caused the glut and it will be from shale that supply is cut.

Chart 1: WTI crude 2006–2016, US\$/bbl



Source: EIA, 2016

Why would that happen now when it hasn't happened earlier?

The decline has taken so long because of hedges and debt-funded capital expenditure. Now hedges are rolling off and debt is being called in: so far this year, over 160 shale producers have gone bust, hundreds of rigs have been demobilised and output has started to fall (see Chart 2).

“ It was US shale that caused the glut and it will be from shale that supply is cut.

The shale industry is shrinking. This month alone, shale output should decline by about 100,000 barrels of oil per day (bopd) and, because shales require constant drilling to maintain output, that decline will accelerate.

Chart 2: US oil production, 2011–2016, mbopd



Source: Ycharts, 2016

We expect that legacy shale wells will start to decline by about 250,000 bopd within months and, with drill rig numbers still falling (drill rig numbers are the lowest in almost 30 years) total shale output will decline by almost 2m bopd by the end of the year, almost eliminating the oil surplus.

Many expect that, as oil prices recover, shale production that has been turned off will simply be turned back on again. That appears to be the hope of many producers who have drilled prospective locations and are now awaiting a profitable oil price to frack and produce additional barrels.

Thank the Fed

Higher oil prices will no doubt encourage some additional output but we don't expect a large-scale resurgence of US shale. Why not?

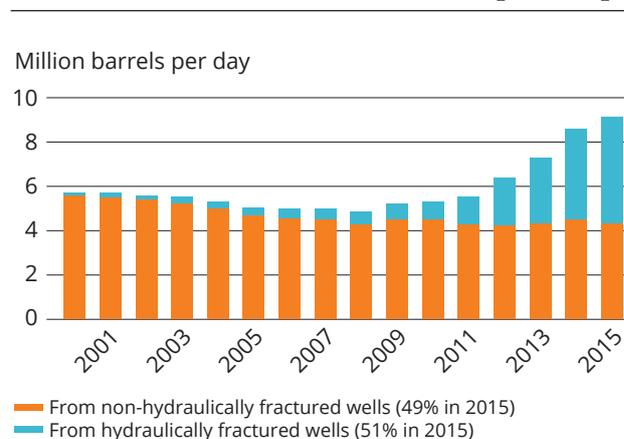
The shale revolution was made possible partly by advancements in drilling technology but also by ultra-low interest rates and a surfeit of lenders. In Texas, they thank God for putting oil in the ground; they ought to

thank the Fed too, because zero interest rates and copious bank lending have helped sustain the shale boom.

From 2006 to 2014, debt in the oil industry tripled from \$1 trillion to US\$3.3 trillion. That's three times the size of Australia's economy going to finance one industry. Over the same period, the largest 18 oil firms quadrupled their capital expenditure plans to almost \$400bn, much of it being spent on expanding shale output (see Chart 3).

Conventional oil production actually decreased during that time, while shale output rose from 100,000 bopd to over 4m bopd. There is no doubt the cash poured into shale production created the oversupply.

Chart 3: US shale and conventional oil output, Mbopd



Source: EIA, 2016

It was cheap money that transformed shale from an experiment into a threat to the oil establishment. A lack of cheap financing could just as easily turn it back.

The end of shale?

Now the oil price is back where it was in 2004, yet the industry is still swimming in debt. Strained balance sheets will take years to repair and we should expect low investment for a long time – \$380bn worth of projects have already been shelved and activity has ground to a halt.

“ As barrels are produced but not replaced, global supply will ultimately shrink and prices will once again climb.

Since peaking in 2011 at 2,000 rigs, the overall rig count in the US today is just 400. The Eagle Ford Shale, the epicentre of the boom with arguably the best economics in the US, boasted 217 rigs at its peak; that number has fallen to just 29.

Without balance sheet strength or bank support, production declines will be hard to arrest even at higher prices. Beyond that, we remain sceptical about the economics of shale production. We highlighted those concerns in *Einhorn vs Klarmen: the future for shales* which, in summary, argued that shale is uneconomic even at US\$100 oil.

Not a single shale producer has sustainably generated free cash flow and the largest dozen producers have reported operating deficits of US\$80bn which had to be financed from debt and asset sales. All that at US\$100 oil. At lower prices, the economics don't improve.

Yet shale represents just 5% of global production and capital expenditure cuts are industry wide. Oil fields, as we know, decline without investment so the capex strike today is sowing the seeds of tomorrow's boom.

As barrels are produced but not replaced, global supply will ultimately shrink and prices will once again climb to encourage investment. This was a cyclical business in the boom and it is cyclical in the bust.

If we eventually expect oil prices to recover should we be buying energy stocks today? That is where we'll turn our attention in Part 2.

Staff members may own securities mentioned in this article.

The big four energy stocks are no longer oil producers: they're LNG businesses. The traditional link between oil and LNG risks being broken.

Is it time to buy oil stocks?

Part 2

In Part 1 of this series we argued that oil prices would rise. The surplus responsible for the collapse in prices began with US shale, and that sector is likely to see dramatically lower output as stretched balance sheets no longer support production.

Key Points

- **LNG pricing could change**
- **Debt remains a problem**
- **Price guides restored**

Company info

COMPANY (ASX CODE)	MAX. WEIGHTING	RECOMENDATION
OIL SEARCH (OSH)	4%	HOLD
ORIGIN ENERGY (ORG)	4%	HOLD
SANTOS (STO)	3%	HOLD
WOODSIDE PETROLEUM (WPL)	6%	HOLD

With output expected to fall by almost two million barrels of oil per day (bopd), sustained higher oil prices are likely to encourage new production. With that expectation, we are on the hunt for Australia's best oil exposure. It is shockingly difficult to identify.

You might expect that the biggest energy names on the market – **Woodside, Oil Search, Origin** and **Santos** – would fit the bill. Yet these businesses are no longer oil producers, they're LNG giants.

Oil and LNG have long been linked but that link is a historical quirk that could soon end.

Spot the market

LNG was once a revolutionary idea that allowed gas to be transported and traded without the use of pipelines. Early LNG markets were characterised by a small number of buyers and sellers who contracted supply for decades at oil linked prices.

Today, the LNG market bears little resemblance to its former self. Traditional buyers such as Japan, Taiwan and Korea which only a decade ago accounted for about

90% of the market, are now competing with China, South America and Europe for LNG cargoes.

The number of countries importing LNG has grown from a few to 30 over the past 15 years, while the number of LNG exporters has doubled to 25. The LNG market is now deeper and more liquid with a burgeoning spot market.

As more buyers and sellers transact, the spot market will expand and, over time, LNG should trade on its own supply and demand fundamentals rather than piggybacking off oil with which it shares little other than organic chemistry. A growing gap between spot and contract pricing (see Chart 1) heralds a permanent decoupling.

Chart 1: Singapore spot LNG price

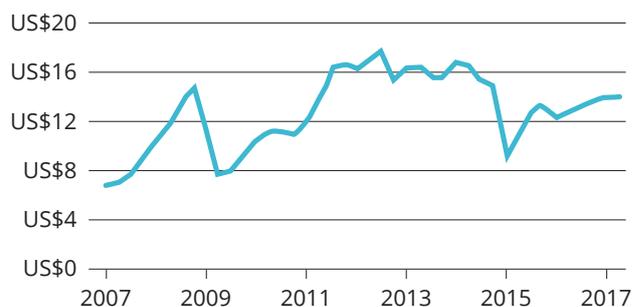
Singapore spot LNG Price



— SLInG Prices – \$ mmBtu on 1/18/16 (L1)

Source: Singapore Exchange Ltd., ICE Futures Europe

LNG average contract price, (US\$/mBtu; Japan basis)



— SLInG Prices – \$ mmBtu on 1/18/16 (L1)

Source: World Bank; The Economist Intelligence Unit

“ With more productive gas wells and lower costs, Origin presents a more tempting target.

While contracted LNG averages around US\$12 per million British thermal units (mmBtu – a unit used to measure gas production), spot prices hover at just over US\$5/mmBtu. Japanese and Chinese buyers are already demanding new contract terms, and pressure to lower contracted rates – regardless of what the oil price is doing – will grow. Traditional LNG pricing is under dire threat.

Qatar’s RasGas, one of the largest producers, has already agreed to halve contracted LNG prices for Indian customers.

At the pointy end of these structural changes lie four local gas giants, each dominated by LNG. Oil Search, Santos and Origin have each completed mega LNG projects that have cost more than US\$60bn collectively and two of them – Santos and Origin – are among the most expensive LNG suppliers in the world.

Table 1 shows our estimates of the per unit cost of production for LNG projects from all four giants. It is not just a damning indictment on individual projects, it speaks to the exuberance of the industry over the boom years when costs soared and ambition reigned.

Table 1: Est. cost for LNG projects, US\$/boe

	BREAK EVEN COST	COST EXCL. FINANCE
WPL	US\$12	-
GLNG	US\$50	US\$40
APLNG	US\$40	US\$30-35
PNG LNG	US\$30	<US\$20

Woodside appears relatively low cost because it operates legacy projects that were built in a lower-cost environment and are largely depreciated. Debt has also been mostly repaid. PNG LNG still boasts attractive economics but both APLNG and, in particular, GLNG will struggle to generate decent rates of returns.

These projects will increase cash flow (we have detailed our own estimates [here](#) for Origin and [here](#) for Santos) and, if oil prices reach our expectations, each will make money. Yet debt remains a key problem and means that potential losses are large should we be wrong on oil.

Santos

As Table 2 shows, Santos and Origin carry dangerous levels of debt. Although Origin carries more debt in total and in relative terms, it can service the higher load thanks to the high and stable cash flows from its energy retail business. Santos cannot.

Santos also operates a relatively stable domestic gas business but it is capital intensive and doesn’t generate enough cash on its own to repay debt. Lower oil prices remain an existential threat and the company relies on rising prices to meet debt repayments.

Table 2: Net debt

	TOTAL, \$BN	% OF MKT CAP
WPL (US\$)	5.8	25
STO	6.3	74
ORG	9.0	90
OSH	4.5	42

The balance sheet makes Santos a leveraged play on oil – it will benefit more from higher oil prices – but it also introduces unacceptable levels of risk. The one salvation is that a break-up of Santos will likely yield more value than the market capitalisation today.

Santos’s 13% stake in PNG LNG alone could produce \$5-6bn if sold; enough to repay debt entirely. The rest of the business, with a book value of \$13bn, is being valued by the market at less than \$2bn. At higher oil prices, that is likely to be wildly pessimistic but, at lower oil prices, it could be prophetic. While Santos is cheap, its balance sheet is dangerously stretched. Santos is too risky to buy but it is too leveraged to sell. **HOLD.**

Origin

With more productive gas wells and lower costs, Origin presents a more tempting target. Table 3 outlines our bear case, with a US\$50 oil price, and a bull case, at US\$90 oil. The numbers suggest that Origin is worth between \$4 and \$11 per share depending on your view on oil.

“ Woodside is the elder statesman of local LNG and legacy assets have protected it from the bust.

We've weighted the oil price closer to US\$70 than US\$50 so the fact that the current share price is above our buy price suggests that the market is more comfortable with Origin's debt level or is more sanguine about its future. An alternative is that the market is starting to price in a possible break-up of the business.

Table 3: Origin valuation (\$m)

	US\$50		US\$90	
	EARNINGS	VALUATION	EARNINGS	VALUATION
RETAIL	800	10,000	1,100	13,750
PRODUCTION	100	2,000	400	4,500
APLNG	400	4,000	1,000	10,000
DEBT		(8,500)		(8,500)
CORP COST		(800)		(800)
TOTAL		6,700		18,950
SHARES (M)		1,750		1,750
\$/SHARE		3.83		10.83

Origin chief Grant King recently suggested that splitting the business into an energy retailer and an LNG producer may make sense. That would likely lift the valuation of the total because low interest rates increase the attractions of a stable, potentially high dividend paying utility retailer.

We don't want to be paying for that speculation although we acknowledge that there is rationality to it. Origin is the most interesting of the big four producers and we would consider upgrading around \$4.50. For now, **HOLD**.

Woodside

While peers have struggled, Woodside has watched. An operator of two high quality LNG projects, Pluto and the North West Shelf (NWS), Woodside is the elder statesman of local LNG and legacy assets have protected it from the bust. NWS is a fully depreciated cash cow and, although considered dear when built, Pluto enjoys lower costs and higher margins than newer projects.

Despite two splendid assets, Woodside faces well publicised growth problems: the NWS is running out of gas and will

need fresh investment within four years; Browse, another potential LNG project, is unlikely to happen; and there are few obvious ways to raise output.

Woodside has bought a stake in the Wheatstone LNG project and its exploration efforts in Myanmar have recently yielded gas but production is years away. With an excellent balance sheet, we are a little disappointed that Woodside hasn't been more aggressive over the downturn, instead electing to pay dividends at an unprecedented payout ratio of 80%.

That can't last forever and we expect dividends to be cut as new projects are eventually built.

Without debt concerns or cost burdens, there has been little to worry about and that is reflected in the share price. As Table 4 shows, Woodside is almost spot on our valuation of \$27 a share. That number assumes oil prices of US\$70 a barrel but is relatively conservative as it omits smaller assets entirely.

Table 4: Woodside valuation, US\$bn

	EARNINGS	BOOK VALUE	VALUATION
PLUTO	1,500	13,000	15,000
NWS	1,000	3,400	5,000
AUST OIL		760	500
WHEATSTONE		3,000	3,000
NET DEBT		(5,800)	(5,800)
CORP		(800)	(800)
TOTAL		13,560	16,900
SHARES (M)		842	842
US\$/SHARE		16	20
\$/SHARE		21.47	26.76

Woodside is operating splendidly and is well led. There is little to complain about, but with few problems come few opportunities. The business is fairly priced; we're interested in cheap. **HOLD**.

“ With outstanding returns even at today’s oil price and improving economics as the project expands, Oil Search boasts the best financial returns of any energy producer on the ASX.

Oil Search

Oil Search is the hardest of the big four to value. PNG LNG arguably boasts the best economics of any recent LNG project. Vast onshore gas reserves require few wells and the existing two-train facility can easily be upgraded with one or two additional processing facilities. As good as PNG LNG is, it could get even better.

That prospect is more likely if Oil Search is able to complete a takeover of rival PNG gas producer Interoil, and plug newly discovered gas into its original development. An alternative plan, to build a separate LNG facility in PNG, risks replicating the mistakes made over the course of Queensland’s LNG boom.

With outstanding returns even at today’s oil price and improving economics as the project expands, Oil Search boasts the best financial returns of any energy producer on the ASX.

If the project were located in Queensland or WA, PNG LNG would be worth over US\$40bn, implying a valuation for Oil Search of about US\$13bn, or A\$17bn. That equals about \$11 a share and ignores higher output that might come from new gas.

So why is Oil Search stock trading at less than \$7 a share? Because the market has factored in a PNG discount.

No one can dispute the value of the LNG project. The squabble with Oil Search is always how much of a country discount to apply. I’ve worked in PNG in the past

and seen its dysfunction first hand. My view on the size of the discount? Make it big.

There is a reasonable argument that the current discount is adequate. The Interoil acquisition, should it happen, would be a grand victory for Oil Search, allowing it to lift output at minimal cost and generate exceptional returns without increasing debt. That potential deserves consideration and highlights what has long been hidden: Oil Search chief Peter Botten has been one of the best, least recognised CEOs in corporate Australia.

Country risk will never be conquered but can be controlled by discounting your valuation and using a low portfolio limit. We’re lifting our Buy price to \$6.50. Oil Search is within a whisker of being upgraded but remains a **HOLD** for now.

Despite relatively low oil prices, then, there is little at the big end of the energy sector to excite. Origin and Oil Search are close to upgrades; Woodside sits bang on our valuation price; and Santos is too risky for now.

There are, however, a few other options. In the final part of this sector sweep, we’ll look at the oil futures market, a few ideas in the services sector and uncover the best ASX listed oil exposure.

Staff members may own securities mentioned in this article.

There are a few ways to get oil exposure. Here, we look at one smaller producer, a cracking small cap idea and the best big oil exposure on the market.

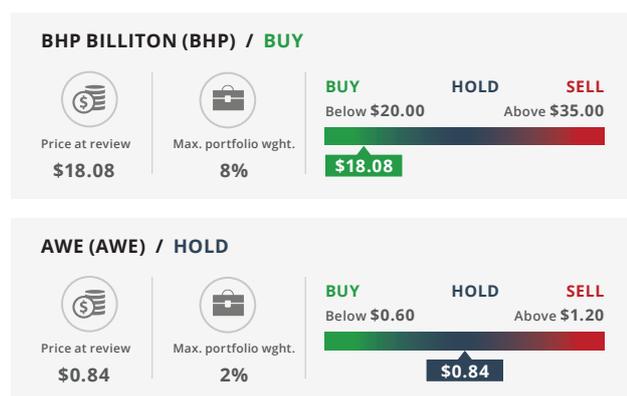
Is it time to buy oil stocks?

Part 3

In Part 1 of this sector sweep we argued that sustained higher oil prices were likely as production from the vaunted shale sector declined.

Key Points

- **Oil ETFs and futures don't appeal**
- **Services firms are higher risk**
- **Two production ideas**



Exposure to higher prices has, however, been fiendishly difficult to find. In Part 2, we noted that the big four energy stocks on the ASX are now exposed to LNG rather than oil and that the historic link between LNG and oil prices – a quirk of history – is likely to end.

If the big four aren't perfect proxies for oil, why not buy something that is? A universe of derivatives and ETFs has opened to retail investors in recent years and you can now get oil exposure through these structured products.

We aren't against ETFs per se; gold ETFs that are backed by metal are wonderful products for those inclined towards the shiny stuff. Oil ETFs are a different matter.

The most prominent product is perhaps the Betashares Crude Oil Index ETF which trades under the mischievous ticker of OOO. This ETF, however, tracks another oil index – the S&P GSCI Crude Oil Index.

Unlike GOLD, which is backed by real gold in a real vault that can't be lent to anyone, OOO buyers have a promise

to track an index that promises to track the oil price. It is an indirect way to capture direct exposure.

The S&P index, in turn, tracks short term oil futures rather than Brent or WTI. This means that investors pay a 0.7% management fee for the ETF and also pay for storage and delivery of product like any other futures contract. Costs build quickly to make this an unattractive way to get oil exposure.

The small guys

If the big end of the sector isn't quite as oil heavy as hoped, what about the smaller end? Here there are more problems of greater consequence; a small resource base, balance sheet woes, high costs and high risks are just some of the reasons we prefer not to dabble in the smaller end of the market.

For those interested, though, the best of the smaller oilers is perhaps AWE, which has rapidly transformed its business in response to the price slump.

Long beset by cost overruns, lower than expected returns and poor exploration results, AWE has now simplified its business, selling its US shale assets for a tremendous sum, getting out of Indonesian gas, reducing exposure to the BassGas project and selling the declining Cliff Head oil project offshore WA.

The result is a better-quality business with a large onshore gas resource in WA and a promising oil project in Indonesia.

Proceeds from asset sales have repaired the balance sheet, which now boasts over \$60m in net cash, and calls on capital have been slashed.

From next year, gas contracts that locked in low domestic gas prices will start to roll over and substantially higher prices will be reflected in results. Miserly returns of the past will improve.

The most exciting development comes from WA, where the largest onshore gas resource in 30 years has been

“ If oil prices rise, deep sea drilling will be among the first activities to return and revenue should once again grow.

discovered. With access to nearby pipelines and low development costs, the Waitsia gas project will be among the lowest-cost sources of supply in WA.

Combined with attractive west coast gas prices, this will be a high margin, long life project and, with additional development, AWE could increase expected output by a factor of 10. Joint venture partner Origin is currently selling its 50% stake in the project and AWE is well positioned to emerge as a buyer.

The Ande Ande Lamut oil project, offshore Indonesia, is also likely to be developed should oil prices reach our expectations. A joint venture with Santos, this is a 100m barrel resource that will need oil prices closer to US\$70 to be profitable. If developed, AAL will double AWE's output and add disproportionately to profit. Historically a gas producer, AWE is now leveraged to oil prices.

Table 1: AWE valuation

	\$M	\$/SHARE
BASSGAS	80	0.15
WAITSIA	150	0.28
OTWAY	30	0.06
TUI	10	0.02
AAL	180	0.34
NET CASH	60	0.11
CORPORATE	(70)	(0.13)
TOTAL	440	0.83

Table 1 outlines our valuation for the business and it is deliberately conservative. Waitsia output could climb considerably over time and AAL would be worth more once fully developed. A sum of the parts method suggests AWE is worth around \$0.80 per share today.

Considering our conservative assumptions, AWE isn't expensive today but nor is it cheap enough to buy. We have a refreshed recommendation guide and would upgrade around 60 cents. For now, **HOLD**.

The services guys

Of course, you don't have to buy a producer to be exposed to oil. This market downturn has been accompanied by an unprecedented collapse of investment in new supply and, apart from shale producers, oil services firms have suffered more than anyone.

Locally, there are several candidates that might be worth looking at. The obvious one is **WorleyParsons**, a darling over the boom years and a giant of the industry. A provider of services, Worley is fiendishly hard to value and carries plenty of debt. With large competitors and even larger customers, margins that have halved over the past few years will be hard to lift. The business is still mired in losses and, on an EV/EBITDA of 8, doesn't appear particularly cheap.

Another option might be more interesting. Matrix Composites is a manufacturer of riser buoyancy, the high tech material that encases subsea equipment used on offshore oil projects. Over the boom years, demand was high and revenue poured in; so much so that Matrix decided to build the largest syntactic foam (the stuff that makes riser buoyancy) factory in WA.

You can guess what happened next. Debt rose, sales collapsed and today Matrix is a fraction of its former size.

Revenue has shrunk and profits are less than \$1m but the balance sheet is clean and Matrix is the lowest-cost producer of syntactic foam in the industry. Its products are cyclically depressed rather than obsolete and the company can afford to wait while demand recovers. It now trades at just 50% of net tangible asset value, which includes a new best-in-class manufacturing facility.

If oil prices rise, deep sea drilling will be among the first activities to return and revenue should once again grow. Matrix is too small for us to cover formally but it is among the best oil exposures on the market.

“Buying cyclical businesses only makes sense in tranches rather than one go.”

What if tiny, unprofitable services businesses aren't your thing? There is another option.

The biggest ... and best?

Who is the largest oil producer on the ASX? You might think Woodside, but no; the crown goes to **BHP Billiton** which produces over 250 million barrels of oil equivalent (mmboe) per year, more than twice Woodside's 92mmboe. If considered alone, BHP Petroleum would be among the top 20 oil producers in the world.

Despite being the largest, BHP can be a problematic oil exposure. It is simultaneously among the world's largest producers of iron ore, coking coal and copper, activities which dilute the exposure to oil. Yet the attractions of the oil business are clear and often underappreciated.

Unlike the smaller producers, BHP generates huge cash flow, boasts quality producing assets and, crucially, a large proportion of output (and an even larger proportion of profit) is oil. Woodside, though mainly an LNG business, has a significant oil business too but it lost money last year.

Last year, petroleum accounted for 35% of BHP's asset base, 25% of revenues and 15% of profit. The sheer size of the asset base – over US\$40bn in all – means that any increase in returns has a meaningful impact on profit. Oil may not seem meaningful from last year's result but that can quickly change as prices rise.

BHP's profits are most sensitive to changes in the price of iron ore – a US\$1 change moves profit by about US\$150m – but it is also highly sensitive to changes in oil prices. A US\$1 change in the price of oil will move profit by about US\$60m. Iron ore prices matter to BHP, but so do oil prices.

Conventional quality

A focus on BHP's underperforming shale assets often overshadows the fact it operates some of the most productive and lowest-cost conventional oil fields anywhere. BHP pumps conventional oil at a cash cost of under US\$11 per barrel, placing it in the bottom quartile of the global cost curve and below industry giants like Shell, BP, ExxonMobil and Chevron.

The conventional oil business produces over 120 mmboe annually and, even at today's lower oil price, still generates

operating margins over 70%. BHP has used the slump to increase leases in the Gulf of Mexico and has significant lease holdings in the Caribbean and offshore WA. There is ample opportunity to increase output at high incremental rates of return.

Shales aren't as lucrative: they account for more than 50% of the petroleum asset base but last year generated losses of US\$1bn. BHP will never generate outstanding returns from shale but, given its enormous asset base, improving returns could be meaningful.

BHP holds the best shale positions in North America. In the Permian and Eagle Ford Shale it can generate cash flow at oil prices as low as US\$15 and total output should rise beyond 100mmboe this year.

We've expressed scepticism about the long-term economics of shale wells. That scepticism carries a caveat: a business with a large balance sheet and huge resource position can extract profitable output at the right location and at the right oil price.

Shale is characterised by sweet spots – areas along otherwise homogenous shale rock where oil has been cooked and pressurized to perfection. BHP's Permian and Eagle Ford Shale positions sit along such a sweet spot. They claim the best cost and pay back metrics in the industry and are the focus of BHP's shale empire.

We were perhaps hasty in our initial upgrade but buying cyclical businesses only makes sense in tranches rather than one go.

The world's pre-eminent miner also comes attached to one of the biggest oil businesses anywhere. It's not a perfect exposure; the petroleum business is diluted by BHP's other mines but it isn't lost among them. As oil prices recover and remain persistently higher, BHP's profits will rise materially. The biggest oil producer on the ASX is also the best. **BUY.**

*Note: The Intelligent Investor **Growth** and **Equity Income** portfolios own shares in BHP Billiton. You can find out about investing directly in Intelligent Investor portfolios by [clicking here](#). ■*

Disclosure: The author owns shares in Matrix Composites.

Staff members may own securities mentioned in this article.