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INTERVIEW with Arjun N. Murti, Energy Analyst, Goldman Sachs

What Mr. Crude Oil Sees Ahead

By LAWRENCE C. STRAUSS

AN INTERVIEW WITH ARJUN MURTI: Gas may have to hit \$5.75 a gallon before consumption cools enough to take the heat off fuel prices.

IN 2004, ARJUN N. MURTI, A TOP ENERGY ANALYST AT GOLDMAN SACHS, published a report predicting "a potentially large upward spike in crude oil, natural gas and refining margins at some point this decade." It was a controversial call, with crude around \$40 a barrel at the time. But it was right on the money.

Four years later, crude is trading around 139.

Murti sees energy in the later stages of a "super spike," in which prices rise to a point where demand drops off. In a note last month, he wrote that "the possibility of \$150-to-\$200-per-barrel oil seems increasingly likely over the next six to 24 months."

With supply growth constrained and global demand staying strong, prices must rise further, in Murti's view. Barron's caught up with him last week in his New York office.

The 39-year-old analyst doesn't give many interviews and keeps a low profile, preferring not to be photographed. But his strong views on energy have resonated across the financial markets.

Scott Pollack

"We don't think the world has run out of oil. We do think [many producers] aren't on track to grow their supply aggressively." --Arjun Murti

Barron's: What do you make of Friday's big surge in oil prices?

Murti: There have been a number of bullish fundamental data points recently that contributed to the rally. These include further declines in U.S oil inventories announced June 4, the announcement of a decline in Russian oil production in May, and recent comments that Mexico expects further meaningful declines in oil production over the rest of this year.

Longer-term, what's driving crude to such high levels?

Spare capacity throughout the energy complex seems very limited, whether for OPEC crude oil, natural gas or refining. In all of those areas, capacity is limited. And it's getting very difficult for companies and countries to boost supply -- something that became increasingly apparent to us over the first half of this decade.

Our view started shifting, from one of "It is easy to grow supply," which was the perceived view of the 1990s, to "It is going to be more difficult to grow supply." That's partly because some oil-producing regions, like Mexico and the North Sea, are declining. The Lower 48 states in the U.S. are very mature.

There are growth areas, such as Brazil and Angola. But when we add up all those pluses and minuses, non-OPEC supply looks like it is not going to grow very much.

So, essentially, there is constrained supply, along with increasing demand?

Demand has been consistently growing. On the supply side, we don't subscribe to the peak-oil view. We don't think the world has run out of oil.

We do think that the places that have large quantities of recoverable oil, notably Saudi Arabia, Iraq, Iran, Venezuela and Russia, aren't on track to grow their supply aggressively. It is growing at a very moderate rate, and so the remaining oil resources are concentrated. And, to some degree, high prices are disincentivizing some of these countries to either open up their industry or spend the money themselves.

What actually is keeping them from producing more?

These countries don't need the incremental revenue. They're getting the revenue through price; they don't need it through volume. It means they have sufficient capital to try and develop their oil industry on their own. With high prices, they don't need Western capital. Venezuela, where Western companies' assets have been expropriated, is a good example.

You've made the distinction in your research that while the world's oil supply is barely growing, if at all, there is a lot of oil that's not being taken out of the ground. Take Russia, for example. Why aren't they producing more oil?

In a lot of the key oil-exporting countries, the government is the key driver of whether their oil fields get developed. Relative to 10 years ago, Russia is in a very healthy position.

So, logically, there is less incentive for Russia to massively grow their supply and bring down oil prices. Frankly, that's true for a lot of these countries.

In terms of your super-spike scenario, what phase are we in?

We are getting closer to the end game here, where despite eight years of rising energy prices, supply looks like it is going to barely grow this year. We have

been bullish, but we didn't expect such a slow growth rate of supply. And demand outside the U.S., Europe and Japan has been more resilient than we expected.

What markets are you referring to?

That would include China. The Middle East is a big demand driver, though it is often underappreciated. In aggregate, Middle East demand is about the same size as China's and it's growing at about the same rate. Demand from Latin America is also increasing.

Let's talk about the possibility of crude hitting \$200 a barrel. If we get there, how does it play out?

Our view has been that the price will keep going up to the level where it meaningfully reduces demand. This is Economics 101; we need more supply or less demand. And because there are various political and geologic constraints on growing supply, we're left with looking for the price at which demand is reduced. We've never thought we knew what that exact number is. But we've tried to look at the 1970s, notably the economic impact of gasoline prices that ultimately led to a reduction in demand.

How does the current situation compare with the 1970s?

In the 1970s, you had a traditional supply shock. You took a bunch of oil off the market, and the price rose very quickly in a short period of time. That led to lower demand that proved sustainable, because the market worried that the supply wouldn't come back. It has been, up until the last three or four months, a much more gradual increase -- and therefore, people have generally been able to get used to the price. And it's allowed demand to be more resilient than even we thought it would be.

But if crude does hit \$200 a barrel, what kind of prices will we see at the pump?

Oil at \$150 to \$200 a barrel would imply between \$4 and \$5.75 a gallon.

At which point you probably see a falloff in demand, right?

We are already starting to see a drop in demand in the U.S., but they are still having demand growth in the non-OECD countries, including China, the Middle East and Asia. The OECD [Organization for Economic Cooperation and Development] countries are mainly the U.S., Europe and Japan. The real question: At what point do the non-OECD economies slow down? The other thing about U.S. demand is, at what point do you have sustainable change in consumer behavior? So if the price temporarily goes to \$4 [a gallon], but immediately falls back to \$3, it's likely that people will keep driving cars with poor gasoline mileage. But if people believe the increase in oil prices is more sustainable, they might shift to taking mass transportation, if available, driving hybrids or taking the other kind of actions that are necessary to reduce demand on a sustained basis.

Do you see a sustained drop in demand at \$200 a barrel?

That is the big question. We have always assumed that, at some point, you get a sustained drop in demand. Our long-term oil forecast looking out 20 years is [for crude] to fall back to \$75 a barrel, or some lower number. The questions are: How long do prices stay high? How sharply do they rise? And do people truly change their behavior or are they just temporarily driving less? It's an unknown at this point.

There's been a lot of discussion about speculators driving up commodity prices.

Oil markets are driven by fundamentals. Our response to the notion that it is merely a bubble is that you are still seeing no supply growth. If the price isn't real, where is the supply?

Where are natural-gas prices going?

Our thesis has been that LNG [liquefied natural gas] wouldn't arrive in the U.S. in anywhere near the quantities people expected, because LNG prices are so much higher in the rest of the world. In a country like Japan or Korea, they are now paying \$18 to \$20 per million BTUs [British thermal units]. Our natural-gas prices have risen to around to \$12 million per BTU. Europe is \$13 to \$14 [million], so we have amongst the lowest natural-gas prices in the world. Therefore, it makes less sense for companies to ship liquefied natural gas to the U.S. For LNG to come into the U.S., we would have to have much higher natural-gas prices than the rest of the world. So either prices would have to fall in the rest of the world or they would have to rise here. Also, natural-gas inventories in the U.S. are tightening, putting upward pressure on prices.

You are pretty bullish on energy. But you're Neutral on the refiners.

The challenge for the refiners right now is that we are starting to see the U.S. experience negative gasoline-demand growth and the U.S. refiners are very tied to gasoline margins, which are likely to be lackluster if gasoline demand growth is negative. There is also higher ethanol production. The bottom line is that U.S. refiners get squeezed.

One group you and your colleagues do like is the integrated oil companies. Why?

Right now, the market seems to be very pessimistic on the integrated oils. I think the market is worried that there may be windfall-profit taxes.

The market has also taken the view that if you're bullish on oil, you're better off owning E&P [exploration and production] companies or oil-services companies. And, again, the market has generally factored in lower oil prices than we think are likely. All this makes the major oils look very inexpensive.

As of last week, the major oils, including ExxonMobil [ticker: XOM], ConocoPhillips [COP] and Chevron [CVX] were trading at about eight times earnings, based on oil prices of \$110 a barrel. They were trading at four times enterprise value [stock-market value plus net debt] to Ebitda [earnings before

interest, taxes, depreciation and amortization]. That's fairly inexpensive by historical measures.

Table: Murti's Picks¹ Do any of these companies stand out?

ConocoPhillips is our overall top pick among the major oils, partly because they have more oil in OECD countries. The tax rates tend to be a little bit lower in those countries than they are in some of the non-OECD countries. They've also got a large natural-gas position, which they got when they acquired Burlington Resources several years ago. In the two years after they bought it, natural-gas prices fell. So the market has taken a pessimistic view of the Burlington Resources acquisition. But now, with natural-gas prices rebounding to around \$12 per million BTUs, those assets should be performing a lot better.

Another sector you favor is exploration and production.

The E&P companies tend to be more leveraged to natural gas, where we also have a fairly bullish outlook. Gas prices have been very inexpensive over the past couple of years, and they are just starting to recover in the U.S. So some of these natural-gas E&P companies are big beneficiaries of that. Also, many of these E&Ps are now in some of the newer natural-gas shale plays, like the Barnett Shale in Texas, the Fayetteville Shale in Arkansas and the Horn River Basin in British Columbia.

Our top pick is Cabot Oil & Gas [COG], one of the smaller companies, with a market capitalization of about \$6 billion.

We like their exposures to some of these specific shale plays, including the Marcellus Shale in Appalachia. Because they are a smaller company, some of these new areas can have a disproportionate impact on the size of their reserves and production. Another company in this group that we like is Apache [APA], which is larger, with a market capitalization of about \$45 billion. They have a nice balance between crude and natural gas and domestic and international exposure. We think international natural-gas prices are likely to start rallying, and Apache has got a good position in Egypt and Australia. And they have a number of key assets domestically.

All of these companies look very inexpensive because the market hasn't factored in anything near the current oil and natural-gas prices. Based on our numbers, Apache's enterprise value was recently at four times Ebitda and Cabot's was a little bit more expensive at 6.5 times Ebitda.

What other sectors look attractive?

Pipelines. The pipeline companies don't directly benefit from higher commodity prices, as would integrated oil or E&P companies, but there is a great need to expand our pipeline infrastructure in this country, and a lot of the companies we favor are positioned to do just that. Oneok [OKE] and El Paso [EP] are two we like. El Paso has a very large natural-gas pipeline network, and it looks undervalued to us. As for Oneok, they are well-positioned to benefit from a lot of natural gas in the Rockies and some of these mid-continent shale plays.

Are there any calls you wish you could have back?

We stayed too bullish on the U.S. refiners for too long, and that has been a mistake.

What most concerns you about energy stocks, going forward?

The biggest risk is that emerging-market growth abruptly changes for some reason. It is hard to predict that reason, but if it changes, it will probably change suddenly. That's what we worry about.

As for the possibility of \$200 oil, that's not sustainable in your view, right?

No, we call it a spike, which implies an upside and a downside. So we don't talk about a sustainable price of \$200. We call it a peak price, but we don't know what that is. We've got a range of \$150 to \$200.

Thanks very much, Arjun