EVALUESERVE

Energy Intelligence: Impact of Covid-19

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Energy: The What?

Global Activity and Critical Updates at a Glance

Oil prices have tumbled over 50% to $26/bbl, triggered by Covid-19 and accelerated by price war between Saudi Arabia and Russia

North America

- The Covid-19 outbreak led to a global oil demand shock, which is expected to decline for the first time since 2009 by 1.1 million barrels per day (mmbpd) in 2020. This triggered the decline in oil prices, which was further accelerated by the disagreement between OPEC+ and Russia over continuing with production cuts (supply shock).[1]
- US oil and gas (O&G) producers are likely to be impacted the most with deteriorating demand as current prices are below the breakeven costs for the majority of the producers.[2]
- The O&G producers in North America have cut their 2020 budgets by 30% amid declining demand and shrinking profits due to Covid-19.[3] S&P is reviewing its O&G coverage to factor in the impact of the outbreak on free cash flow.[4]
- Cost reduction measures have already been announced by several O&G players, and the industry is likely to experience significant workforce reduction in the near term.[5]

EMEA

- As the O&G industry is struggling with Covid-19, Saudi Arabia decided to boost its oil output by 27% to 12.3 mmbpd in response to Russia's decision to exit OPEC+ oil production cut agreement. The Kingdom also dropped its selling price by $6/bbl for Asia, which marked its biggest month-on-month price cut historically.[6]
- Russia, in response, can increase its production by 0.5 mmbpd to a record high of 11.8 mmbpd.[7]
- Following the disagreement, ruble declined 7% to a four-year low of 74 to a US dollar.[8] Notably, one ruble drop in the exchange rate increases revenue by ~$970 million from taxes on energy exports by Russia.[9]
- North Sea O&G industry is facing challenges related to supply chain, such as the sourcing of vital equipment for maintenance, and transportation of workers to offshore locations.[10]

APAC

- China is struggling with increased supply of oil products on declining consumption. Its oil demand is expected to decline 10% YoY in 1Q20, and the refiners cut their utilization by 25% month-on-month in February.[11]
- China is increasing oil products exports, which are expected to hit a record high in March, with an overall increase of 58,000 bpd, or 3.9% YoY in 1Q20[12] – adding to an already oversupplied global oil products market.
- Exports will likely grow as the outbreak spreads and will put additional pressure on oil products' margins, which are at multi-year lows.[13]
- Chinese LNG importers are sending "force majeure" notice to their suppliers amid declining industrial and commercial activity.[14]
- South Korea, the fourth largest petrochemicals exporter, is reducing refinery utilizations amid declining demand due to Covid-19.[15]

Analyst Note

Global oil market was expected to balance in the second half of 2020, driven by production cuts from OPEC+, favorable demand growth, and stagnant non-OPEC supply growth. However, the Covid-19 outbreak lowered oil and oil products' consumption of the largest consumer (China), and the Saudi Arabia-Russia disagreement will result in an extremely oversupplied market (at least in the short term) – shrinking the bottom line across the majority of the energy value chain, and adding to an already challenged industry.

Sources: 1) IEA, Mar 2020 2) Dallas Federal Energy survey, Mar 2020 3) Reuters, Mar 2020 4) Financial Times, Mar 2020 5)The New York Times, Feb 2020 6) Bloomberg, Mar 2020 7) Investors.com, Mar 2020 8) RFERL, Mar 2020 9) World Oil, Mar 2020 10) S&P Platts, Mar 2020 11) S&P Platts, Mar 2020 12) Economic Times, Mar 2020 13) Reuters, Mar 2020 14) CNBC, Feb 2020 15) Pulsenews, Feb 2020

Energy: The So-What?

Near-Term Risk Outlook, Risk Mitigation, and Opportunities

Segment	Level of Risk and Opportunity: Near-term risk	Level of Risk and Opportunity: High impact region	Potential Disruptions	Risk Assessment	Opportunity Assessment
Upstream	High	US and Middle East	Reduced production; Increased financial distress	• **US Shale**: Oil prices below the break-even costs; Decline in drilling and completion activity; Increased financial distress, potential bankruptcies and credit ratings downgrades • **Offshore**: Operations of offshore platforms impacted with the outbreak likely to be suspended • **NOCs**: Budget shortfalls in lower oil price environment	• Capital discipline and operational excellence will be required • Companies to reassess their asset portfolios and divest non-economical assets
Midstream/LNG	Medium	US and Asia	Stranded oil cargoes and force majeure	• Chinese LNG importers are reneging on supply contracts[14]; Lower consumption can lead to additional force majeure • Natural gas prices in the US will be supported by decline in associated natural gas output - as producers reduce their oil output	• Lower LNG demand from China will prompt exporters to explore alternative markets • Midstream companies will experience reduced volumes and can reassess their contracts with the producers
Downstream	High	US and Asia	Refinery utilization and financial stability	• Lower feedstock costs improve margins, but a global slowdown will lead to decline in demand • Demand for jet fuel to drop significantly due to lockdowns • Financial stress for debt-ridden Chinese teapot refiners[16]	• Reduce refinery utilization and explore alternative markets for oil products • Storage business likely to benefit in current dynamics
OFS/Drillers	High	US	Asset utilization and financial stability	• Lower utilization on capex cuts by producers • Contracts renegotiation by producers • Bankruptcies and credit ratings downgrades on uncertain sector outlook	• Additional cost reduction and efficiency improvement measures will be required • Increased consolidation and restructuring • Diversification of earnings required

Sources: Mar 2020 14) CNBC, Feb 2020 16) Economic Times, Feb 2020

Energy: The Next-What?

Long-Term Sector Implications for Professional Services

Upstream

Significant O&G sector headwinds offer professional services opportunities

Professional services firms should prepare the US O&G companies for the three-pronged threat: lower oil prices, declining investors confidence to divest from fossil fuel companies, and significant debt levels.

- **Capital discipline and operational excellence**: With oil prices below the breakeven costs for the majority of the producers, opportunities for efficiency improvement, technological advancements, and efficient supply-chain procurement are likely to be explored.
- **Debt restructuring services**: The US O&G industry has about $86 billion of debt due by 2024 and nearly all of the debt is currently rated "BBB", or below. Additionally, the industry is experiencing declining investor confidence and deteriorating free cash flows, which will add to the debt refinancing challenges and likely result in significant credit rating downgrades in the near term.[17] Debt restructuring services can help effectively refinance the upcoming debt maturities.
- **M&A services:** Deals opportunity will exist as companies will optimize their asset portfolios and divest non-economical assets to survive the downturn.
- **Bankruptcy services**: US producers that adopt hedging have ~43% of their 2020 oil production hedged[18], which can help them survive the downturn in the short term. However, several unhedged producers may file for bankruptcies if lower prices are sustained.

Oil Field Services (OFS) and Drillers

OFS/drillers will be hit the most; offering opportunities to professional services firms

The current events have made the near-term outlook for the OFS/drillers highly uncertain as the dramatic moves in oil prices will result in lower spending by producers, which in turn, will put additional pressure on utilization, dayrates, and well completion activity – providing a bouquet of opportunities to professional services firms.

- **Bankruptcy and M&A services**: Since 2015, 200 OFS/drillers have filed for bankruptcies in North America, and an additional 30% are expected to consider bankruptcy or consolidation. Likewise, in Europe, more than 20% of the OFS companies are likely to file for bankruptcies.[19] Notably, S&P ratings have two-thirds of US OFS companies rated "B" or below, and two-thirds of drillers are rated "CCC+" or below.[20]
- **Debt restructuring services**: Considering the majority of the US OFS/drillers are in a non-investment grade category, a rating downgrade will limit the refinancing options and significantly increase the cost of debt– increasing interest expense and adding pressure on the cash flows of the surviving players.
- **Operations consulting services:** OFS/drillers will battle for market share due to oversupply of services and pressure from producers to renegotiate their contracts. Cost cutting and downsizing are likely to be more prominent in this sector in the near term compared to upstream.

Analyst Note

Large energy companies are increasingly adopting the digital and contactless modes of operation amid the outbreak – providing opportunities for technological enablement through big data, advanced analytics, and IoT for their operations.

Sources: 17) CNBC, Mar 2020 18) CNBC, Mar 2020 19) Yahoo Finance, Mar 2020 20) S&P, Feb 2020

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Long-Term Sector Implications for Professional Services

LNG

Professional services firms can target both LNG sellers and consumers

Lower LNG prices create opportunities for both low-cost sellers and large consumers of the commodity – LNG is a long-term story, and the segment's dynamics will eventually improve.

Several US companies are re-evaluating their planned LNG expansions owing to the decline in spot prices: Exxon Mobil is likely to delay its giant Mozambique LNG plan. Fewer projects taking a final investment decision in 2020 and 2021 will help somewhat balance the markets between 2024 and 2027.[21]

- **Strategic cost management services**: LNG companies with relatively low cost structure (such as Cheniere Energy) have an opportunity to explore additional cost efficiency and technological advancement initiatives along with strategic contract negotiations to gain market share in the medium to long term.
- **Procurement services**: The current dynamic presents an opportunity to large consumers of natural gas (such as the industrial energy buyers globally), and economies looking to switch from coal to gas for electricity generation (such as India and South Korea) to revaluate their gas procurement strategies.

Refining

Professional services firms can help refiners navigate through the dilemma of increasing utilization or adopting a wait-and-watch strategy

In a lower oil pricing environment, the refiners typically see an increase in profitability as the price of oil is the most important input cost for them. However, with the travel bans and lock-downs due to the Covid-19 outbreak, the prices of gasoline and jet fuel have plummeted too. The refiners are in a dilemma to choose between reducing utilization and extending maintenance activities, or ramping up to take advantage of lower input costs to fill up storage with refined products.

- **Commercial advisory and performance improvement services**: Considering the anticipated oversupply in globally traded markets, professional services can help refiners navigate through the challenges of feedstock and product price volatility, and striking a balance between maintenance and utilization rates – keeping storage capacity limitations and consumption rebound factors in mind.
- **Debt restructuring and bankruptcy services**: Chinese private refiners significantly increased their crude imports during the first two months of 2020, assuming the outbreak and demand would recover soon. An extended period of the outbreak will further intensify their debt levels and default probability (as they have continued spending on modernizing infrastructure and procuring crude on a global scale despite lower refining margins over the past few years [22]).

To Watch Out For

Covid-19 is a crisis unlike any other in recent times, and as the global energy sector struggles with the pandemic, the services of consulting firms are likely to become more important than ever.

Key industry metrics to keep an eye on – The weekly change in the North America rig count, US crude oil production, and refinery utilization rate to see how the energy sector responds to the outbreak as well as the movement in Asian LNG spot prices as select consumers of the commodity in the Chinese economy partially return to operations.

Sources: 21) World Oil, Mar 2020 22) BNN Bloomberg, Feb 2020