

Is now a good time to invest in Big Oil?



By Peter Cooper on Saturday, March 21, 2009

Buying energy stocks when oil prices are below \$50 ought to make a great deal more sense than at \$147 like last July. Yet even the great Warren Buffett made that error in buying shares in Conoco Phillips last summer as he admitted to his shareholders recently.

Emirates Business talked to oil analyst Ashton Lee who manages the Dubai Shariah-compliant hedge fund specialised in energy about buying assets while prices are low.

What drove oil prices up so fast last summer and why are they now so low? Can prices get lower?

In retrospect, we clearly had some momentum building that speculators accelerated. It made sense to many industry participants that oil would become much more expensive over time so we probably, as a group, failed to see that it was moving far too fast.

But frankly, if the United States mortgage debt and derivatives problems hadn't derailed the banking sector, we think crude oil would still be pretty expensive.

Can it go lower? For a while it could, but we think we are past the point in pricing where supply will fall off pretty quickly thereby providing a price support level close to where we are now.

Does currency affect the value of oil reserves? Can oil rise if the US dollar stays strong?

Most oil is priced in dollars, so when the dollar is strong producers may have some ability to accept a lower dollar price.

Our view however is the dollar is extremely vulnerable. The US needs to borrow a huge amount of dollars to finance the economic recovery efforts. We've seen estimates that the Treasury needs to sell three times as many bonds this year as last year.

I'm not sure how eager foreign investors are going to be to increase their exposure to American assets at this point, and a reduction in petrodollar and China-dollar demand for US bonds could severely weaken the currency.

Our bet is for US currency weakness, accompanied by an increase in the dollar price of oil. In other words, we expect inflation when the currency is measured in terms of oil.

How has your energy investing changed with oil prices down?

Certainly we are much more concerned with the debt levels of the companies we invest in than we have ever been before. A great many energy companies have become cheap. But the imperative for investors is to invest only in those that have the balance sheet strength to be survivors, come what may.

Also, we have become even more attuned to current income. If we are going to have depressed markets for a considerable time then we see a high dividend as an attractive way to make a return, while stock prices may stay low.

Finally, in the past we had a tendency to use margin when stock prices were attractive.

We are being more cautious about that now than we were before. We need to balance the fact that we are seeing very attractive investment values with the fact that we are in a bit of a new and unknown world.

In the past we made a lot of money thinking pretty much entirely about energy matters. Now we need to worry about much broader economic matters, like the health of the US financial system.

Lucas Energy has built its reputation by being experts in the royalty trust space, what is this?

There are actually quite a few types of royalty trusts. What they all have in common is that they receive the revenues from oil and gas production, and exist to distribute this to their unit holders. So they are a way to essentially own a part of the cash flows from oil and gas production.

US royalty trusts actually collect royalties on properties they own and which are handled by third party operators. They function somewhat like countries whose fields are operated by royalty paying multi-

national oil companies. Generally US royalty trusts have little or no debt.

Canadian royalty trusts are operating entities that were established to distribute much of their cash flows, and at least for now benefit from an absence of taxation at the entity level.

They are much like the better-known real estate investment trusts that are structured to distribute the cash flows from commercial properties.

For some perspective, trusts typically provide current income yield in the range of eight per cent to 15 per cent, whereas typical corporate energy companies offer yields in the range of zero to five per cent, with relatively few in the upper end of this range.

Will inflation help or hurt investments in the energy markets?

Almost by definition inflation is good for the price of commodities in dollar or other currency terms.

Of course, the costs of producing those commodities also rise with inflation.

The thing you really want to own in an inflationary world are companies who have already paid to drill their wells or build their mines and which can then produce their output without incurring the current costs of developing their assets.

Canadian Oil Sands Trust is one good example of that. They have been producing oil from the Canadian Oil Sands region for over 25 years now, and have their facilities largely in place.

What they built for \$5 billion (Dh18.35bn) would cost a new operator probably \$15bn to replicate. So they can operate profitably in a world of \$60 oil where a new operator might require \$100.

You have recently begun managing Shariah funds. How is this different?

It's not all that different. We have always believed in low leverage. And generally we have not been attracted to shorting stocks or gambling in futures. In the energy business, when one company does well, most do well. So shorting isn't that attractive to us.

I'd rather spend the time looking for the best companies with the best fundamentals and not worrying why people might be paying more than we would for other companies.

Who's Ashton?

Ashton Lee is the portfolio manager of the Lucas Energy Total Return Funds, the four hedge funds offered by Lucas Capital Management. He joined LCM at the end of 2002.

But Lee spent the majority of his early career at the Leo Burnett Company as a Senior Vice President, managing large international

advertising accounts, although during that time he maintained an active investment interest in energy equities.

He received a Bachelor of Arts degree in Economics from Northwestern University in 1973 and an MBA from Kellogg Graduate School of Management in 1975.

Lucas Capital was founded in 1996 and advises over \$750 million (Dh2.75bn) across four hedge funds, three private equity funds and a private wealth management business.

The firm is a continuum of three generations of Lucas investment experience dating back to 1934. The firm started investing in energy related royalty trusts in 1975.