INTELLIGENT INVESTOR
SHARE ADVISOR

Bargains in the Oil Patch

■ EFY 2015 Special Report

Intelligent Investor Share Advisor

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A letter from the Research Director

Dear Intelligent Investor,

In just four months late last year, the oil price halved. Almost everyone was taken by surprise. But it made a point about the international oil market that has been struggling to achieve mainstream acceptance.

You don't hear much talk of peak oil anymore. Neither does anyone doubt that hydraulic fracking - drilling down into the earth and then injecting a high-pressure cocktail of water, sand and chemicals to release oil and gas from rock – has fundamentally changed the global oil market.

In 2008, the United States was producing five million barrels of oil a day. Thanks to the shale oil revolution, that figure has now almost doubled, carrying with it the prospect of the US one day becoming the world's biggest oil producer. As a consequence, the ability of OPEC and Saudi Arabia to influence global oil prices has diminished.

But fracking is expensive. Most producers need prices of at least US$60 a barrel to break even. The recent oil price collapse is a result of OPEC countries returning fire, pushing the price of oil down to make life difficult for the new kids in the oil patch.

The *Share Advisor* analytical team has long held the view that oil is becoming harder and more expensive to find, drill and produce. That implies an oil price higher than historical norms. Our 2009 special report ***The Case for Oil*** and its 2012 follow up ***Is there still a case for oil?*** make that point strongly and clearly.

Against that light, the recent oil price collapse offers an enticing opportunity. The aim of this report is to find a basket of stocks that will benefit from a higher oil price but won't disappear down a sinkhole if oil prices remain low or fall further.

That prospect was made easier by conducting a worldwide search. In identifying stocks in the US, UK, Canada, Norway and Spain, we were able to find more attractive, safer and higher quality businesses than we could in Australia.

Of course, these stocks are cyclical. The entire sector is suffering from cuts to oil and gas exploration and production budgets. But these six businesses, each with the skill and wherewithal to extract increasingly hard-to-get oil at reasonable prices, should enjoy long term prosperity. Best of all, right now they're cheap.

If and when the oil price recovers to reflect the marginal cost of finding and extracting a barrel of oil, there's an excellent chance of double digit annualised returns.

We suggest keeping things simple. The oil price can do crazy things in the short-term so consider buying some shares today and maybe adding more if the opportunities improve with lower prices. Allocate no more than 10–15% of your portfolio to this basket of stocks and if you're a very conservative investor, keep your exposure to no more than 5%.

We trust you'll enjoy and profit from *Bargains in the Oil Patch*.

Yours sincerely,

Nathan Bell,
Research Director,
Intelligent Investor Share Advisor

The case for oil (again)

The US shale gas revolution might have led to a global oil glut, but there's a very good reason why this increase in supply won't lead to lower long term oil prices.

In the midst of a supply glut and an oil price crash, plus the growth in renewable energy, it's difficult to imagine why oil might be a source of opportunity right now.

So before unveiling the six stocks in our oil patch portfolio, let's confront that issue head-on and explain the oddly counter-intuitive case for higher oil prices in the face of increased oil supply.

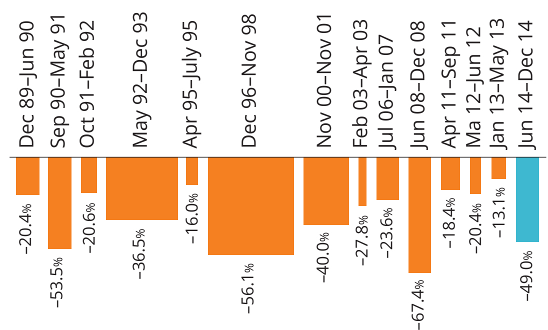
Ever since Henry Ford invented the Model T, humanity's thirst for oil has grown. Wars have been fought over 'black gold' and without it much of what we have come to know as the modern world would cease to be. Oil is central not just to our economic lives, but has played an elemental role in how our species has developed and prospered.

> *Only twice in the past 30 years has the price of oil not moved by more than 40% over a two-year period.*

As wealth has increased, so has demand for oil. Humanity's thirst for it has been difficult to slake, at least until last year when the oil price halved. Warnings about peak oil then quickly evaporated as fears turned to where the oil glut would be stored.

The speed of the decline was shocking, but the extent of the slump shouldn't have been. The effects of US fracking on global oil supply had been well publicised and oil price volatility has been an accepted feature of global commodity markets for decades. Only twice in the past 30 years has the price of oil not moved by more than 40% over a two-year period, as Chart 1 reveals.

Chart 1: Major slumps

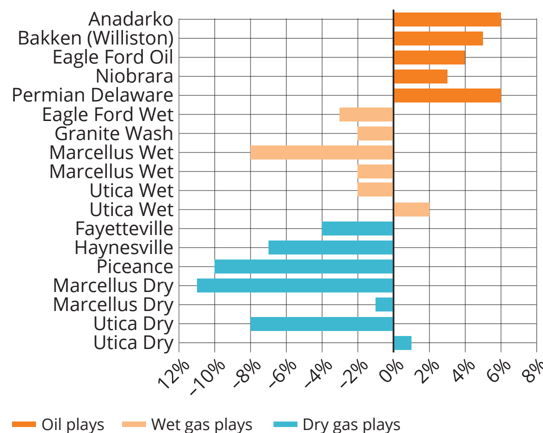


Source: Business Times

Each day, the globe consumes about 100m barrels of oil. Remarkably, it took a surplus of just 3% for the oil price to halve. In the 1980s, when the world was consuming about 60m barrels a day, a surplus of 10m barrels was required to produce such an effect.

What makes the analysis more challenging this time around is the variation of prices at which US fracking is profitable (see Chart 2). Fracking has not only added to global production at a time when the global economy appears to be slowing, but it has helped marginalise OPEC, which has historically been a stabilising force on the market. Last year, 84% of global oil supply growth came from US shale.

Chart 2: US shale return on capital



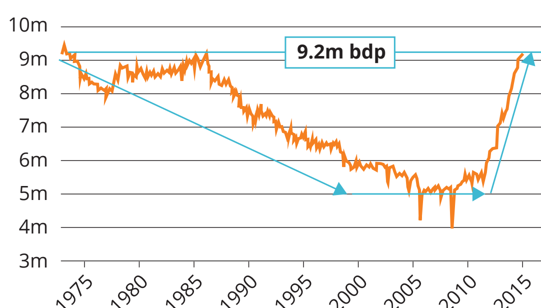
Source: covestreetcapital.com

Despite a massive fall in the number of operating rigs, oil production is hitting record new highs, as Chart 3 shows. What does this mean for the oil price? As the marginal cost of producing an extra barrel of oil is next to nothing, some observers expect the oil price to fall to US$20 a barrel. Saudi Arabia shows no signs of slowing production and Iran may add to the glut if economic sanctions are lifted.

But these two countries are suppliers of conventional oil, where the marginal cost of producing an extra barrel of oil is extremely low. That is not the case for US frackers, which face an entirely different and more challenging business model.

The problem with fracking is that 75% of a well's capacity is exhausted in the first year. Jeremy Grantham of GMO believes that over 80% of US fracking production from current wells will be at an end within three years. As he remarks, only 'the financially desperate and the irrationally impatient' will drill new wells at current prices.

Chart 3: US crude oil production, 1973–2015



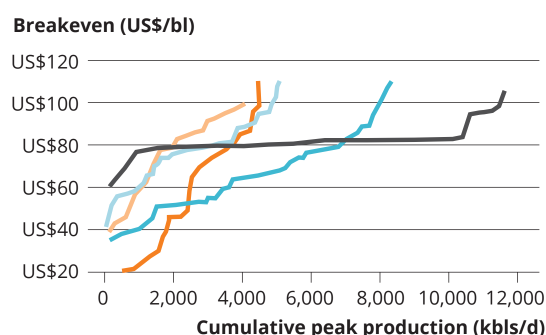
Source: Business Insider via valuewalk.com

That's what the producers of traditional oil are banking on. As in the iron ore market, OPEC's low cost producers are increasing supply to cause long term damage to higher cost (read: unconventional) producers.

The plan appears to be working. At current prices most highly leveraged marginal players are unprofitable. With banks like Wells Fargo already boosting provisions for bad debts, the reduction in lending will slow fracking production.

> *Only 'the financially desperate and the irrationally impatient' will drill new wells at current prices.*

Chart 4: Breakevens of non-producing and recently on-stream oil assets, US$/bbl



Traditional Deepwater Ultra deepwater Heavy oil
"Shale oil"
Source: Goldman Sachs Global Investment via www.valuewalk.com

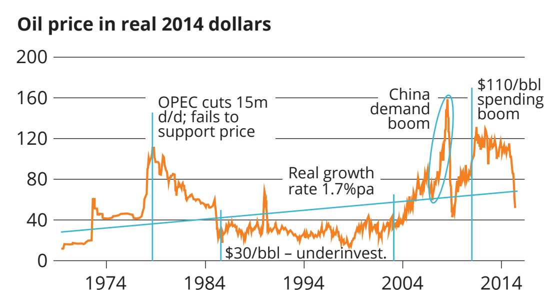
In ***Pondering things way out of our control***, Cove Capital explains that at US$40 per barrel there isn't a fracking company that will cover its cost of capital. That should put a floor under the price of oil (see ***The media has it wrong when it comes to oil***).

The world also exhausts 2–3% of its oil reserves each year and new discoveries are frequently difficult and expensive to exploit (see Chart 4). Eventually, the oil majors will need to spend heavily to replace their reserves.

The question is not whether the oil price will eventually increase, but rather whether the oil and gas service providers that we've analysed have the balance sheets to withstand large exploration budget cuts until fracking production exhausts itself or a higher oil price encourages investment. Make no mistake, this is a war where those with the deepest pockets and lowest production costs will prevail.

Of course, no one can know with any certainty what the oil price will be at any given point. But common sense – and standard economic theory if you're into that kind of thing – suggests that eventually the oil price will reflect the true cost of discovering oil and getting it out of the ground. Best guesses put that medium term figure at US$60–80 per barrel, as Chart 5 shows.

Chart 5 : Oil price in real 2014 dollars



Source: Energy Information Administration, Pzenz Analysis

It's worth noting however that Jeremy Grantham believes the price could rise to US$100–150 once fracking wells are exhausted in five to eight years. That's unless a major new source of supply is found or renewable fuels take off, which is unlikely while oil prices remain as low as they are.

That's the base case underwriting the six stock picks that follow – the oil price right now is at an unsustainably low level and at some point will rise to reflect the economic realities of the marketplace.

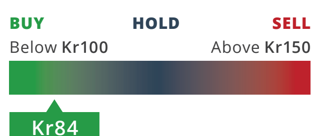
Subsea 7: Value below the surface

With large insider ownership, new contracts and cash to buy back shares, Subsea 7 ticks just about every box on the value investor's checklist.

Subsea 7 (SUBC:OL)

PRICE AT REVIEW	Kr84
MARKET CAP.	Kr 27.4bn
12 MTH RANGE	Kr63.05–Kr127.50
BUSINESS RISK	Med–High
SHARE PRICE RISK	Med–High
PORTFOLIO WEIGHTING	6%
OUR VIEW	BUY

Recommendation guide



**All values quoted in NOK*

A company with large insider ownership often embodies a few sought-after, and increasingly rare, business traits that every value investor should seek out.

Key Points

- **Listed in Norway**
- **Has an ADR listed in the US**
- **Exposed to high cost deep water drilling**

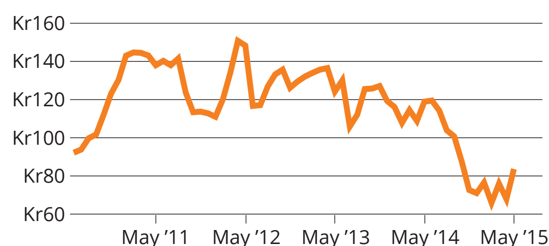
In the Australian market, **ARB Corporation** and **Flight Centre** are two of the best examples of companies run in the long term interests of shareholders because the managers are major shareholders. Unfortunately, the market rarely misprices such companies. But when it does, these can be the best of opportunities.

Deepwater oil services company Subsea 7 is one such opportunity; a high quality business with inside ownership and a cheap price. Company chairman Kristian Siem owns a 21% stake and, unlike some of his competitors, hasn't loaded the company up with debt.

That gives Siem the opportunity to do something intelligent. Subsea 7 is buying back shares after its share price fell 50% in response to the fall in the oil price. With a few ill-structured contracts now lapsing and the industry consolidating, Subsea 7 is one company finding opportunity in the crisis.

Subsea 7's fleet of 39 floating vessels are contracted to major oil companies to safely pump oil and gas from under the seabed to shore. Despite the dangers there are plenty of small rivals, but few have Subsea 7's scale or reputation for managing large, complex and expensive projects.

Chart 1: 5-year share price (NOK)



Source: S&P Capital IQ

French company Technip and Italian company Saipem are its biggest competitors but they're more exposed to exploration than Subsea 7. Neither has the laser-like, exclusive focus on the SURF market (Subsea Umbilicals, Risers, and Flowlines), where a sophisticated network of cables filled with myriad wires, protective equipment and other cool stuff ensures oil and gas can safely travel from the seabed to the surface.

Subsea's expertise isn't manufacturing the cables and pipes themselves, but in connecting and maintaining them in the world's harshest environments. Rigs, wellheads, piping, electronic equipment and massive floating vessels must withstand strong

currents, occasional storms and large variations in temperatures and pressures.

Make no mistake, this is a highly skilled, technical business where things can go wrong very quickly. The Deepwater Horizon blowout in the Gulf of Mexico killed 11 men and reportedly ignited a fireball visible from 40 miles away. Drilling was prohibited across the Gulf in response, impacting every operator in the region. Ultimately, it may cost British Petroleum between US$5bn and $20bn in fines and litigation.

Needless to say, the major oil companies do not want to recruit cowboys for this challenging, treacherous work. That fact delivers Subsea 7 a strong competitive position. With projects becoming more technically demanding, the majors want experienced contractors that can handle ever-larger and more complex jobs. And they prefer to sign them up for long term deals (usually one to five years).

Make no mistake, this is a highly skilled, technical business where things can go wrong very quickly.

With an established position in the industry and a reputation for technical excellence, Subsea 7 is well positioned, especially after investing billions in modernising its fleet of vessels, each of which can cost up to $500m.

The company also invests in pipeline spoolbases in vital locations to make sure there's an adequate supply of piping at a moment's notice, something that also appeases governments that demand foreign investment as a quid pro quo for issuing a mining permit. Again, this is something that adds to the company's competitive moat.

Subsea 7 is the product of many mergers and acquisitions, most recently the 2011 merger with Oslo-listed subsea rival Acergy, a consolidation that has increased profitability. Underlying return on equity was around 16% in 2014, an impressive figure given the company's minimal use of debt. Revenue will fall this year but if the company can produce an average return on equity in the low teens through the cycle then the current price to 'tangible' book value of 0.9 will look awfully cheap.

And the problems? They're pretty much an industry-wide feature; a lousy contract or two. A 2011 agreement for the Guara Lula project owned by Petrobras in Brazil has been weighing on the company's margins and profits, although this contract will soon lapse. Management has created the potential to boost margins and profits with new, more beneficial contracts replacing poor ones like this.

A year ago Subsea 7's share price reached a record of 127 Norwegian Krone (Kr) but by December had dipped to Kr65, before recently recovering to Kr84. Although the company has some exposure to conventional drilling projects, its focus on SURF means the investment case hinges on a recovery in high cost deepwater drilling.

Table 1: Financials

	FY2010	FY2011	FY2012	FY2013	FY2014
REVENUE (KR,M)	18,446	39,363	49,028	49,032	53,492
EBITDA (KR,M)	3,720	6,355	8,130	6,680	10,472
EBIT (KR,M)	2,816	3,973	5,629	3,880	7,390
NET PROFIT (KR,M)	2,067	3,045	6,466	2,723	–2,630
EPS (KR)	11.26	9.41	19.37	8.18	–7.95
PER (X)	21	15	11	17	N/A
DPS (KR)	1.79	–	4.65	4.66	4.58
DIV YIELD (%)	1.3	–	3.5	4.0	6.0

Although the large budget cuts at major oil companies will hurt, Subsea 7's share price has already factored in a large drop in profits. And yet many of these cuts are to exploration projects rather than production, which should affect Subsea 7 less than its competitors.

Existing projects are hard to stop, too. With the bulk of the investment already sunk, even at lower prices it often makes commercial sense for an oil company to keep pumping oil. New deep-water discoveries will also eventually require development as fracking wells deplete.

Subsea 7 also has a US$8bn contract backlog and has won four contracts this year in Australia, the UK, Norway and Brazil. The company also has the balance sheet strength to survive lower oil prices, which may hurt its competitors. It's quite possible that more attractive takeover targets will arise over the next few years as a result. Subsea 7 is well-positioned to take advantage of the turmoil a lower oil price has wreaked.

Nevertheless, earnings will fluctuate with the oil price. But given that Subsea 7 is trading below the value of its net assets (which includes an advanced fleet of modern vessels), if the oil price at least recovers to US$60–70 per barrel then the stock should be worth significantly more than book value. If oil returns to US$100 per barrel and return on equity approaches 20% then the stock could double.

Consider your portfolio limit carefully, as even if this stock performs well eventually an extended period of low oil prices in the interim could trigger a capital raising to keep the balance sheet strong or to finance more acquisitions. But given such low expectations for a well-run business with a strong market position and balance sheet and that's also buying back shares, Subsea 7 is a **BUY**.

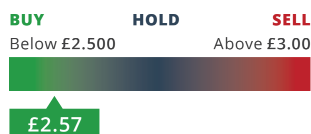
Rotork's flow gets interrupted

Rotork has delivered steady earnings growth over the past 25 years but things are about to get harder. Nathan Bell explains why that's not necessarily a bad thing.

Rotork (ROR:LN)

PRICE AT REVIEW	£2.57
MARKET CAP.	£2.2bn
12 MTH PRICE RANGE	£2.15–£2.89
BUSINESS RISK	Low–Med
SHARE PRICE RISK	Med–High
PORTFOLIO WEIGHTING	5%
OUR VIEW	BUY

Recommendation guide



**All values quoted in GBP*

To paraphrase a former Prime Minister, here's a beautiful set of numbers. Over the past 25 years this company's sales have increased 10% a year, earnings per share have compounded at 14% per year and total annualised shareholder returns (dividends plus capital gains) have reached 18%.

Key Points

- **High quality products give pricing power**
- **Acquisitive strategy**
- **A fairly priced business of exceptional quality**

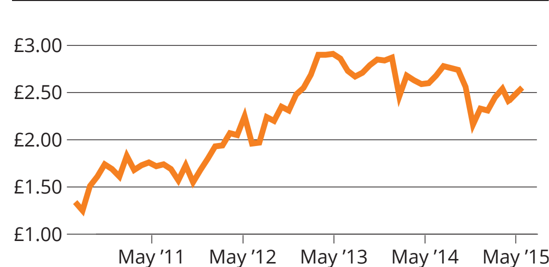
Then there's the stunning return on equity figure of 29%, reflecting a strong market position and 'capital light' business model (more on that soon). And by expanding its range across the world, more customers are prepared to pay a premium for the company's reliable, high quality products. Best of all, since last September the share price has fallen nearly 15% (after initially falling 26%) providing a chance to buy this high quality business at a decent price.

Rotork is the world's largest producer of actuators, motors that regulate the flow of oil, gas and other liquids inside pipes and other transmission and storage infrastructure. Around half of the company's sales come from the oil and gas industry, split evenly between upstream (the source of the oil deposit or flow), midstream (pipelines that deliver the resource to an urban population, for example) and downstream (the processing and purifying of raw material) sectors.

Actuators are small but mission-critical pieces of equipment, the traffic lights in a complex system that regulates the flow of oil and gas. Without them, lives and valuable equipment are put at risk.

Actuators allow valves to do their job by slowing the flow of oil and gas as it approaches its destination. Without them, oil surges can burst through pipes, catch alight and do tremendous damage, which is why a single power plant can have up to 4,000 actuators.

Chart 1: 5-year share price (GBP)



Source: S&P Capital IQ

Compared to the costs of the assets they protect, and the consequences of having an actuator fail, companies tend not to skimp on quality. The beautiful set of numbers described above is a consequence of this fact.

Rotork is well known for its reliable, high quality products. Individual components are sourced from a network of suppliers and assembled in the company's own facilities, ensuring product quality whilst protecting its intellectual property. High margins and impressive returns on capital are the result.

Up until 2014, Rotork had been growing rapidly thanks to a combination of successful new product launches, a series of acquisitions and expansion into new markets. But with most of its sales made outside of the UK (Rotork is listed on the London Stock Exchange), a strong US dollar in particular has weighed on profits, as has a lower oil price.

Acquisitions

Strip out non-cash amortisation costs and the unfavourable currency fluctuations, though, and Rotork trades on a price-to-earnings ratio of around 20 and a 2% yield. For a business boasting a return on equity of 29% with plenty of growth ahead of it, that's more attractive than it sounds. So what might go wrong?

The next year or so may prove challenging but over time we expect Rotork to revert to type and deliver earnings per share growth in the high single digits at least.

We're not overly concerned by the low oil price; the majority of Rotork's oil and gas exposure is to midstream and downstream assets, which are less affected by large exploration budget cuts. The bigger concern is acquisitions. Previous purchases have worked out very well, partly because the company is able to acquire niche products and introduce them to many more customers around the world. The small size of the acquisitions has also kept the risks small.

But last year the company made its largest ever acquisition, the £68m purchase of Young Tech, a South Korean supplier of valve positioners and accessories. Rotork's acquisitions are likely to get larger. Without such an approach the company will struggle to grow annual sales much faster than the industry estimate of 6%.

The company already has a large helping of goodwill and other intangibles. Thus far and with next to no debt, this hasn't been a problem. But should debt increase significantly as the company chases down larger targets, the pain of a lousy purchase would increase.

China's urbanisation has also played a hand in Rotork's rapid growth. Whilst a recession might hurt in the short term, over the long term China will continue to build water treatment plants and other such infrastructure. We'd expect China to continue to be a growing market for the company.

Lastly, after 27 and 30 years of service respectively, the chairman and the research and development director are leaving the business. The board have been good stewards of shareholder interests thus far so we'll be looking for any signs of change as new members are ushered in.

Table 1: Financials

	FY2010	FY2011	FY2012	FY2013	FY2014
REVENUE (£m)	381	448	512	578	595
EBITDA (£m)	103	121	136	157	164
EBIT (£m)	98	112	123	138	142
NET PROFIT (£m)	70	80	89	100	103
EPS (£)	0.08	0.09	0.10	0.11	0.12
PER (X)	24	23	26	27	21
DPS (£)	0.03	0.04	0.04	0.05	0.05
DIV YIELD (%)	1.8	2.2	1.6	1.8	2.2

Rotork's share price isn't on its knees in the manner of many other oil and gas services companies but there's a reason for that; it's a far better business than most. The next year or so may prove challenging but over time we expect Rotork to revert to type and deliver earnings per share growth in the high single digits at least. Remember that over the past 10 years Rotork has managed almost twice that figure. Should that occur, the underlying price-to-earnings ratio would fall quickly, with plenty of growth to come.

If the oil price increases over the next few years, we might be able to double our money on a business like Subsea 7. That's unlikely to happen with Rotork, although anything's possible. The reason why it's earned a spot in the mini-portfolio is due to the company's impressive history, high quality and growth potential. This reliable business adds real quality to our oil and gas portfolio. **BUY**.

Note: Rotork's share price has increased to around the Hold price in our recommendation guide since we started writing this report, but as long as you don't pay too much above the Hold price it won't affect your long term returns too much.

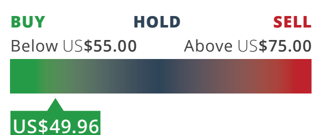
National Oilwell Varco: Big name, small price

The immediate outlook is awful but, as Nathan Bell explains, this company's products are essential to its customers.

National Oilwell Varco (NOV:NYSE)

PRICE AT REVIEW	US$49.96
MARKET CAP.	US$19.4bn
12 MTH RANGE	US$46.08–$86.55
BUSINESS RISK	Medium
SHARE PRICE RISK	Med–High
PORTFOLIO WEIGHTING	5%
OUR VIEW	BUY

Recommendation guide



**All values quoted in USD*

If you think the oil and gas industry is experiencing a regular downturn, Clay Williams, chief executive of rig manufacturer **National Oilwell Varco**, suggests you think again:

'[I]n the first quarter, with global supplies outpacing global demand by one and a half million barrels per day, the oil price signal rolled through our industry like thunder, and thunderstruck participants responded vigorously. Spending is falling in almost all regions, driving the worldwide rig count down by a third since September. The rate of decline of active rigs, most acute across [North America], is breathtaking and unequalled in prior downturns.'

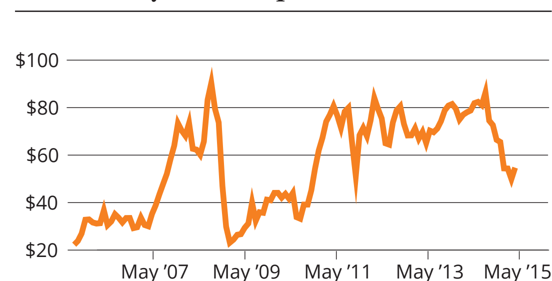
Key Points

- **Scary short term outlook**
- **Management determined to use downturn to its advantage**
- **Strong balance sheet fuelling share buybacks**

Williams's background at National Oilwell stretches back nearly 20 years, so he's no stranger to large swings in the oil price. But this is the first time US shale frackers – a growing source of demand for National Oilwell – have been a swing factor in oil production.

No one in the industry knows when the recovery will come, nor what it will look like, but Williams believes we will know soon, 'because the industry is conducting its first grand, global empirical test of price elasticity of the supply of oil.'

Chart 1: 10-year share price

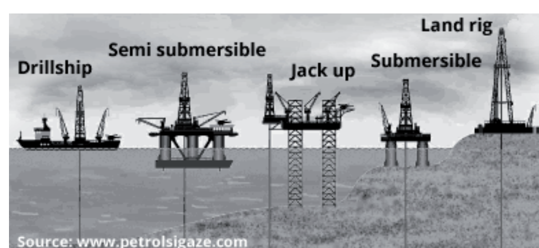


Source: S&P Capital IQ

After more than 200 acquisitions National Oilwell has become one of the world's largest manufacturers of oil rigs. About three-quarters of the rigs the company makes are used offshore (the remainder are land-based) and their cost and complexity increases the further away from shore they operate (see Chart 2). A Jack Up rig costs about $45m – expensive, but a bargain compared to the $200m needed to buy an offshore floating vessel like those used by Subsea 7.

The company, credited with standardising oil rig manufacturing by cutting costs and boosting rig performance, uses a version of the razor and blades strategy made famous by Gillette. Over a 25-year period the company reaps almost as much in maintenance and ancillary sales as it does selling the rig. As Williams says, its network of installed rigs 'is the gift that keeps on giving'.

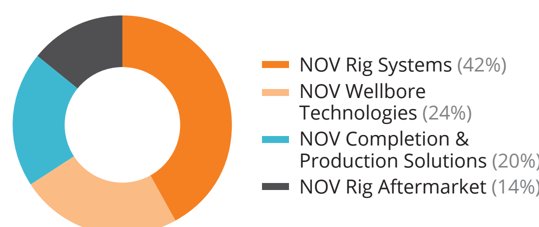
Chart 2: Rig types



The company has four divisions (see Chart 3), and none has escaped the massive cut in drilling and exploration budgets by the oil majors. The Rig division is the largest and has been punished for its exposure to deep-water drillers (a high cost source of oil) and the rapid reduction in operating rigs in the US (see Chart 4).

Unlike the flimsy contracts mining services companies sign in Australia, once a client agrees to buy a rig it will be built and paid for.

Chart 3: NOV revenue by segment (FY2014)



Source: National Oilwell Varco presentation, Mar 2015

Unlike the flimsy contracts mining services companies sign in Australia, once a client agrees to buy a rig it will be built and paid for. National Oilwell's order backlog has shrunk from $14.3bn at the end of 2014 to $12.5bn as new orders to replace completed projects have dried up, but that's still a fair bit of work on hand. Williams expects to complete around $7bn of backlog projects in 2015 so there'll be plenty of work even if new orders only trickle in over the next year or two.

Nevertheless, revenue is expected to drop 30% quarter over quarter and orders are likely to halve. Management is cutting costs by shutting plants, reducing overtime, seeking discounts from suppliers and slowing manufacturing. But it's unlikely costs can be cut fast enough to maintain margins, especially when the company needs to hang on to key staff if it is to emerge from the downturn in a stronger position.

As for the aftermarket division, it's suffering from clients delaying maintenance and upgrades. They're also using parts from idle rigs or running down stock to conserve cash. Whilst not a sustainable strategy, things will deteriorate in the second quarter (ending in June) as tighter client budgets bite.

Chart 4: US oil rig count

Source: Baker Hughes via Business Insider

The company's third division, Wellbore Technologies, develops technologies to help rigs drill faster, further and deeper, through the provision of drill bits, pipes and automated systems. With the active US rig count falling by 66 rigs per week on average in the first quarter, compared with just 55 per week during the 2008/2009 financial crisis, this division is suffering. Only when exploration demand picks up will it recover.

Table 1: Financials

	FY2010	FY2011	FY2012	FY2013	FY2014
REVENUE (US$m)	12,156	14,658	17,194	19,221	21,440
EBITDA (US$m)	2,954	3,492	4,005	3,937	4,495
EBIT (US$m)	2,447	2,937	3,389	3,199	3,717
NET PROFIT (US$m)	1,667	1,994	2,491	2,327	2,502
EPS (US$)	4.00	4.73	5.86	5.46	5.85
PER (X)	17	15	12	15	11
DPS (US$)	0.41	0.45	0.49	0.91	1.64
DIV YIELD (%)	0.7	0.8	0.8	1.3	2.5

The Completion and Production division is the company's smallest but has ridden the wave of demand for deepwater floating vessels. The company claims its equipment can be found on 80% of the world's floating vessels, which explains why clients sometime refer to NOV as No Other Vendor. The immediate outlook is lousy but the company has challenged itself with standardising manufacturing over the long term, as it has done successfully with rigs.

So the short-term outlook for this business is rather scary. But a longer term view presents a far stronger case for buying into National Oilwell now.

In a display of contrarian self-assurance, the company bought back an astonishing 10% of its shares recently.

The first point concerns management and its determination to use the downturn to its advantage. National Oilwell Varco has 'the financial resources to invest in acquisitions, as well as the transformative new technologies,' according to Williams. '[C]yclical downturns provide extraordinary opportunities to deploy capital to better position our enterprise for a recovery. [W]hile we don't know the duration of this downturn, we know that we will be better when the recovery comes.'

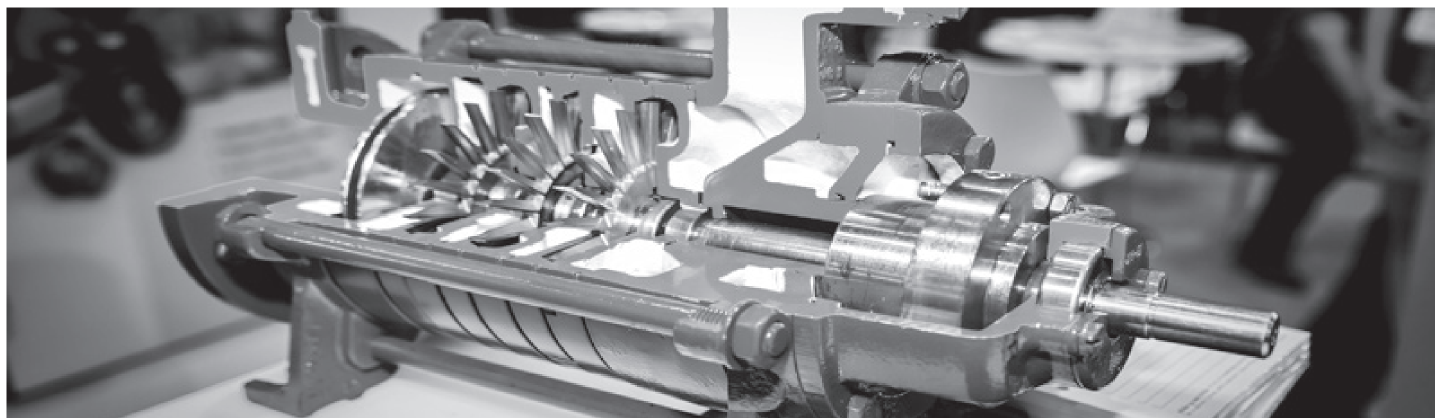
The company's excellent financial position – the second justification - means this isn't just talk. In a display of contrarian self-assurance, the company bought back an astonishing 10% of its shares recently.

Provided things pick up a little in the second half of the year and earnings halve from the prior year, the stock is currently trading on a forecast price-to-earnings ratio of 17, although if the oil price falls again that figure would rise.

This stock doesn't appear cheap. But the trick to buying cyclical businesses – as this one is - is to do so when valuation multiples are high because earnings are depressed. That's the case with National Oilwell now. Returning earnings per share toward $5 over the next three or four years would make this a very attractive investment.

If earnings per share head back towards $6 and beyond as old rigs are retired, new rigs are ordered, day rates recover and major maintenance and repairs can no longer be put off, then the returns get quite exciting.

It promises to be a wild ride but we're happy to be in business with such sensible management willing to take a long term view with everything it does. **BUY**.



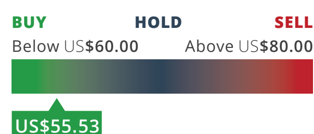
Flowserve pumping and fighting back

Flowserve's first quarter result was a rude shock for management. But as Nathan Bell explains, the company's comeback strategy is as appealing as its cheap pricing.

Flowserve Corp (FLS:NYSE)

PRICE AT REVIEW	US$55.53
MARKET CAP.	US$7.5bn
12 MTH RANGE	US$52.75–$78.97
BUSINESS RISK	Medium
SHARE PRICE RISK	Medium
PORTFOLIO WEIGHTING	5%
OUR VIEW	BUY

Recommendation guide



**All values quoted in USD*

On 26 February, Flowserve reiterated its forecast for full year earnings per share of $3.60-$4.00. That compared favourably to the $3.76 earned in 2014. Management was confident but Mr Market not so much. Unfortunately, it turned out Mr Market was right, with guidance recently cut to $3.25 to $3.65.

Key Points

- **Share price down 32% from peak**
- **Razor blade strategy**
- **Plenty of growth options**

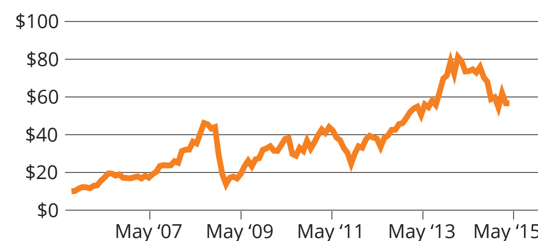
This is a tricky business. Industrial pumps are designed to force huge volumes of raw material through pipes across distances large and small. If the contents of the pipe move too slowly it clogs them up. Too fast and it can eat away at the pipes, causing rust and, ultimately, the possibility of a systemic shutdown.

Both are expensive problems to solve, which is why the valves that control the flow and the seals that ensure liquids and gas can't escape are central to the smooth running of the industry.

Flowserve's systems are customised to their clients' needs, so they have long lead times due to the extensive engineering and testing required. They're a central part of usually huge infrastructure projects that can cost more than Flowserve's annual revenue. These systems must be delivered on time and work as planned, and they must function under extremely demanding conditions.

This is technically challenging work where getting things wrong can cost millions. Reputations built over many decades can be destroyed in an instant, which is why clients favour reliable, proven and proficient supplies.

Chart 1: 10-year share price (USD)



Source: S&P Capital IQ

This is where Flowserve stands out. Just as choosing IBM for your company's IT system won't get you fired, neither will choosing Flowserve for your pipe control systems. The company has a reputation for high quality products backed by timely support.

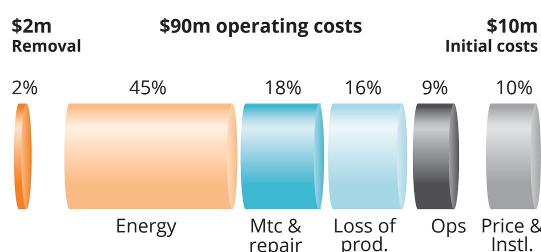
This delivers the company a notable advantage. Because pumps and valves cost a tiny fraction of the assets they support (oil refineries and nuclear power plants, for example) to clients it doesn't matter much if Flowserve charges substantially more than its competitors. Because the extra cost of a mission-critical system delivered by an industry leader is negligible compared with the potential risk and expense of getting something second rate and it going wrong, Flowserve has pricing power.

Then there's the money the company makes from servicing and support. Industrial parts exposed to harsh gases and liquids and extreme temperatures and pressures eventually wear out. The regular maintenance and replacement of parts delivers to Flowserve a reliable source of cashflow, one that's particularly valuable during periodic downturns when major projects are shelved.

"The regular maintenance and replacement of parts delivers to Flowserve a reliable source of cashflow.

This is a typical razor and blades strategy. If a refining pump costs $10m to buy and install, the client will spend a further $90m over the product's lifetime running and maintaining it (see Chart 2). Like National Oilwell's installed base of oil rigs, Flowserve's network of pumps and valves is the gift that keeps on giving, particularly as maintenance work delivers even higher margins than selling the equipment in the first place.

Chart 2: Typical refining pump life cycle costs

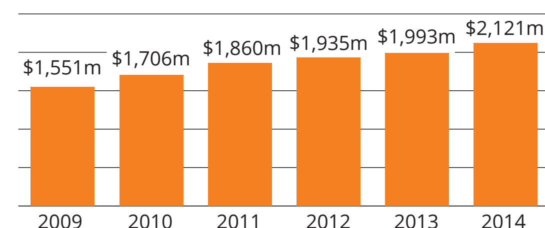


Source: Flowserve Corporation presentation, Feb 2015

Flowserve also operates 71 manufacturing facilities and 175 Quick Response Centres around the world, allowing it to service each and every one of its customers within 24 hours. As manufacturing becomes more commoditised, this ability to improve service levels, nurture relationships with customers and expand its extensive catalogue of products will be central to Flowserve's future success. It's a very significant competitive advantage.

Incredibly, the company's heritage stretches back to 1790. With a worldwide network of over 50 brands, Flowserve has a big advantage over smaller, regional players. While oil and gas companies are slashing budgets in the US, Asia is busy adding coal-fired power plants. This works to solidify Flowserve's dominant market position.

Chart 3: AM bookings in $m

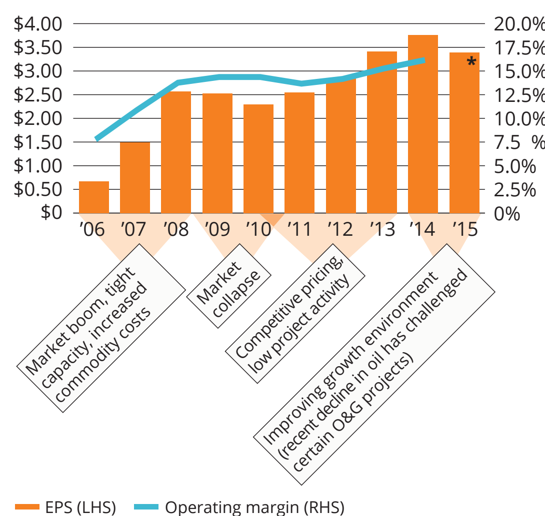


Source: Flowserve Corporation presentation, Feb 2015

In a market where the top 10 global players constitute less than 25% of the total market for valve manufacturing, Flowserve estimates it's the fourth largest player. We believe it is similarly placed in the pump market. With many oil and gas customers shelving projects and delaying major maintenance and repairs, Flowserve is borrowing money at cheap rates to purchase smaller players and build its market share.

Flowserve's balance sheet is in excellent condition and we like the fact that management is hunting for acquisitions while the lower oil price is depressing valuations. The company recently spent $373m on SIHI, for example, adding vacuum and niche fluid pumps to its range. This is a company pressing home its natural advantages at an opportune time.

Chart 4: Earnings stability through the cycle



*Adjusted EPS guidance of $3.25–$3.65
Source: Flowserve Corporation presentation, Feb 2015

Indeed, we expect more acquisitions outside the US when it makes more sense than investing in new facilities, paying tax on cash repatriated to the US or returning cash to shareholders through buybacks and dividends.

Unlike National Oilwell's contracts that work like a Venus flytrap, clients can walk away by paying for any costs Flowserve has incurred.

Flowserve trades on a measly 1.2% dividend yield [DPS = 66 cents] but we'd prefer management to reinvest as much cash as possible in the business if it can maintain returns on equity of over 20%.

Back to that surprise fall in orders and revenue in the first quarter; how has management responded? Staff headcount has been cut by 5%, the company is negotiating for supplier discounts and shifting production to cheaper facilities in Asia and Latin America. Total estimated cost savings are expected to amount to about $70m.

More information

Read this LNG case study.

Flowserve currently has an order backlog of $2.7bn but, unlike National Oilwell's contracts that work like a Venus flytrap, clients can walk away by paying for any costs Flowserve has incurred. So far, unfavourable currency movements have done more damage than cancelled orders but that could change if the oil price falls further.

Due to the strong US dollar, the company's results over the past year have been much better than they appear. In fact, Flowserve's lower estimate of full year earnings per share – $3.25 to $3.65 – includes a $0.40 foreign currency headwind.

This is a first class business currently trading on a price-to-earnings ratio of around 17, despite earnings being depressed by the lower oil price and a strong US dollar, both of which could prove temporary. Given its strong market position, balance sheet and return on equity of over 20% due to its highly successful razor and blades strategy, those multiples could fall quickly over the next few years. That's why Flowserve is a **BUY** and earns a place in our mini-portfolio.

ShawCor's ambitious strategy no pipedream

ShawCor's history dates back to the 1930s but, as Nathan Bell explains, its ambitions are bigger than ever.

ShawCor (SCL:TSE)

PRICE AT REVIEW	$38.44
MARKET CAP.	$2.5bn
12 MTH RANGE	$33.52–$60.63
BUSINESS RISK	Low–Med
SHARE PRICE RISK	Medium
PORTFOLIO WEIGHTING	5%
OUR VIEW	BUY

Recommendation guide

BUY Below $40.00 | HOLD | SELL Above $60.00

**All values quoted in CAD*

Of all the problems in the oil business, two loom over it like no other. First, new discoveries tend to be located in increasingly remote areas facing extreme weather and conditions. Second, the largest and most economical sources of oil tend to reside half a world away from the globe's fastest growing economies in Asia.

Key Points

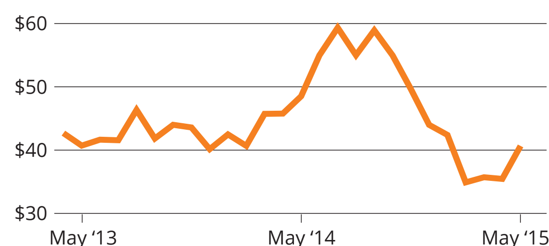
- **Market leader**
- **Scale and technological advantages**
- **Expanding services via acquisitions**

The only feasible solution to those problems are pipes, lots and lots of pipes. Not just ordinary pipes, mind you, but ones that can withstand extreme temperatures; that can deal with enormous pressure at great depths; and can carry corrosive flows of raw materials over long distances, day in, day out, without fail.

Welcome to the world of Toronto-listed ShawCor, the world's largest manufacturer of sophisticated coated pipe solutions with a 25% market share. To understand the difference between the kind of pipes this Canadian company manufactures and those you see emerging from the back of your dunny, consider this; ShawCor's pipe testing facility simulates subsea conditions of depths of up to 3km and temperatures of up to 180°C.

Nevertheless, as with the other companies in this special report, ShawCor hasn't escaped the oil price woes. Because a quarter of the company's business caters to upstream oil and gas projects where oil majors are slashing costs, its share price initially fell 45% after the fall in the oil price.

Chart 1: 2-year share price (CAD)



Source: S&P Capital IQ

In addition, the company's recent results were marred by write-offs from past acquisitions, reflecting the cyclical nature of the oil and gas industry and ShawCor's acquisitive strategy. Profit margins have also been crunched by lower revenues and the completion of some high margin projects.

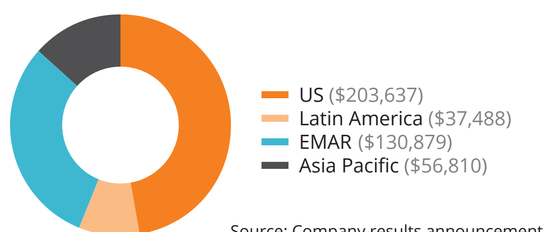
The outlook for the second quarter's results looks dreadful, too. Then there's a $703m order backlog – equal to just four months of revenue – from which

clients can walk away if they choose. Indeed, a contract worth $114m (included in the backlog figure) has already been suspended. These issues show up in the figures. ShawCor's return on equity has slumped from 27% in 2013 to about 8% currently.

At first blush, this is no pretty picture. Whilst a recovering oil price should eventually lead to an increase in demand for ShawCor's treated pipes, what makes the story more interesting are the company's longer-term ambitions to lift financial performance and the strategy used to get it there.

The company is aiming at 15% earnings per share growth and a 15% return on invested capital (the company's definition is similar to using return on equity) through the cycle. Such bold predictions could encourage behaviour at odds with creating lasting value, but management's strategy to take advantage of the many industry tailwinds makes sense.

Chart 2: Revenue for March 2015 Quarter ('000s CAD)



Source: Company results announcement

Coated pipes account for about 5% of the total cost of a project. As with Rotork's actuators and Flowserve's pumps, it doesn't make sense to risk using an inferior product.

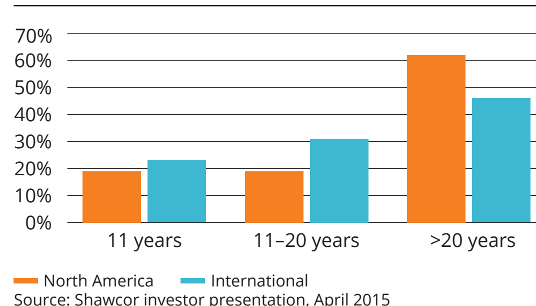
That gives ShawCor a degree of pricing power with its international oil and gas industry clients. And the company's worldwide manufacturing and distribution network offers the necessary financial muscle to make big upfront investments in such large projects. ShawCor's global scale is a huge advantage in a fragmented market.

Through acquiring companies with new technology or services that extend the company's geographic reach, the competition will be squeezed even further. That's one aspect to the strategy, the other is to transform the industry by replacing rigid steel pipes that rust with flexible composite pipes that are easier to install and maintain.

So far ShawCor has only produced a small diameter spoolable pipe. But later this year 6-inch and 8-inch diameter versions capable of operating under pressures of 750 and 1500psi for 20 years will be available, with a 12-inch pipe scheduled thereafter. Management's willingness to cannibalise existing products and revolutionise a market valued at $10bn deserves a big tick.

With over 60% of US pipelines older than 20 years and 50% having outlived their design life (see Chart 3), ShawCor recently acquired Desert NTD, which, like Applus Services, checks and monitors assets to ensure they're running smoothly and efficiently and don't pose any systemic threats to production.

Chart 3: Age of pipelines



Source: Shawcor investor presentation, April 2015

While we like the recurring revenues that compliance and maintenance contracts produce, and the idea of ShawCor's one-stop-shop strategy, we'd prefer the company to focus on widening its moat in pipe coatings.

As the market leader ShawCor has many growth options, but whatever direction it takes, revenue and cashflow will fluctuate with oil and gas prices, economic activity and the frequency of large projects.

If underlying earnings drop about 30% compared to the past two years, we estimate the company is trading on a forecast price-to-earnings ratio of 17. If and when exploration and production spending increases in response to higher oil and gas prices, ShawCor should perform well.

With new products, easily integrated acquisitions and industry consolidation, earnings should increase beyond the record of $3.50 per share in 2013. That means that over the next four to five years the share price could potentially double. If it falls back to closer to $30 then the potential returns would be all the more attractive.

We offer no clues as to the future path of oil prices but we are confident ShawCor will emerge from the downturn in a stronger competitive position than it entered it. **BUY**.

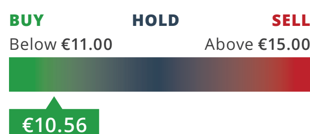
Mr Market gives Applus a C-minus

We've been searching for a safer way to profit from the fall in the oil price. We think we've found it in Spanish company Applus Services.

Applus Services (APPS:MC)

PRICE AT REVIEW	€10.56
MARKET CAP.	€1.4bn
12 MTH PRICE RANGE	€7.53–€17.51
BUSINESS RISK	Med–High
SHARE PRICE RISK	Med–High
PORTFOLIO WEIGHTING	3%
OUR VIEW	BUY

Recommendation guide



**Article initially published on 4 Feb 2015, all values quoted in Euros.*

Busted floats can be a great source of opportunity, and Spanish certification and testing company Applus Services qualifies on the basis that its share price has fallen 43% since listing on the Madrid Stock Exchange in May last year.

Key Points

- **Applus sin-binned due to low oil price**
- **Large margin of safety**
- **BUY for up to 3% of a diversfied portfolio**

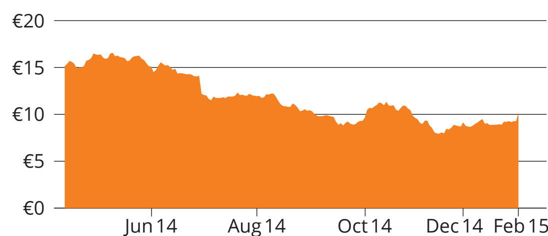
Applus hasn't suffered from the problems you'd expect for a float following seven years of ownership by private equity firm The Carlyle Group: unrealistic growth expectations; an overblown float price; and underinvestment. So often a Cinderella business described in the glossy pages of a prospectus magically turns into a pumpkin, often following write-offs due to lousy acquisitions.

These are still clear and present risks, but Mr Market is running scared because the company's largest customers are the same oil titans that are in a race to see who can cut development spending the most in response to lower oil prices, curtailing the need for Applus's testing and certification services.

Dirty deeds

Around half of Applus's revenue and profits (see Chart 2) come from testing and certifying the major assets of oil and gas companies, and checking that suppliers and service providers are complying with strict agreements. That might mean using ropes to drop men into giant storage tanks to check for corrosion or potential leaks, or checking the welds and nuts and bolts on an interstate gas pipeline.

Chart 1: Applus share price



Source: S&P Capital IQ

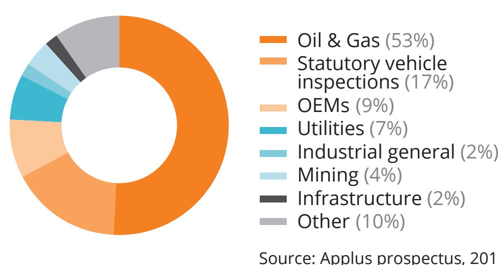
Operating margins aren't high, at around 7–8%, as there are plenty of competitors, though few offer Applus's international scope. There's a bit of technical know-how and ingenuity involved, but Applus's major advantage is that oil titans like Shell prefer to stick with a reliable partner like Applus and often sign

> *As the cost of Applus's services are nominal compared to the expense of a major explosion at an oil refinery, for example, it doesn't make sense to risk skimping on costs.*

long-term contracts. As the cost of Applus's services are nominal compared to the expense of a major explosion at an oil refinery, for example, it doesn't make sense to risk skimping on costs.

Revenues are split evenly between regular checks of existing assets, which provide recurring revenue, and the testing of new plant and equipment. Mr Market is currently concerned that profits from the latter will slump as oil and gas companies slash development expenditure in the wake of the sharp drop in the oil price.

Chart 2: Revenue by end-markets



Source: Applus prospectus, 2014

That's possible in the short term but, as we explained in recent reviews of **Origin Energy** and **Santos**, we expect the oil price to at least recover to the marginal cost of production (our estimate is US$70–80 per barrel) over the next two years or so. Applus's customers like BP and ExxonMobil are household names, and eventually we expect they'll start spending again without any risk that they'll go broke in the interim.

That's important because the company's largest client within this division represents 7% of revenue, and the largest three clients contribute 15%. Eighty per cent of the company's work is also repeat business so losing any of them would be painful, but given the company's excellent reputation we'd still expect this division to grow over time as the world demands more oil and gas.

Duster

Even if we're wrong Applus could still justify its current valuation as it has two other major businesses that provide steady profits.

The first is a highly profitable vehicle inspection division, which essentially provides certificates of roadworthiness. It's like getting a pink slip in New South Wales. Spain still accounts for a third of revenue, but over the years the company has stretched around the world. It has a monopoly in Ireland, for example, which delivers 24% of revenue.

Operating profit margins are around 26%, and while the division provides 17% of Applus's total revenue, it generates 34% of profits. That's because most jurisdictions allow Applus to charge a fixed price for a specified period of time with limited, if any, competition.

The hard part is extending contracts at similar prices. On average Applus's contracts have eight to nine years to run, but given Ireland and the Catalonia region of Spain account for 42% of the division's revenue, losing such highly profitable contracts would be impossible to replace.

Over the past decade, though, Applus has only lost three contracts, while extending nine and winning nine more. Unlike in Australia where virtually any mechanic can perform a check of roadworthiness on your car, many foreign regulators have little interest in liberalising their market, which could reduce prices and Applus's market share. With regulations tightening around the world as more and more vehicles hit the road, there should be incremental opportunities to grow profits.

Das Auto

The other major division performs automotive testing and engineering, and provides 10% of profits. Applus owns 80% of the business with the Spanish government owning the rest.

Applus's customers read like a who's who of the automotive world, including Audi, Ferrari and BMW. While Applus performs all manner of vehicle testing, from seating comfort to engine and exhaust noise, it also helps car manufacturers to comply with foreign automotive standards to expand in new markets. The wide range of services means it's cheaper for them to use Applus's world-class facilities than to develop and maintain their own.

It's not a huge business and won't grow quickly, but it should provide valuable cash flow should the RTD division's profits dry up over the next year or two.

Risks

With so many divisions there's plenty that could go wrong in addition to the oil price staying low. The company is highly acquisitive, and grew rapidly despite the GFC due to Carlyle's debt-fuelled acquisition frenzy.

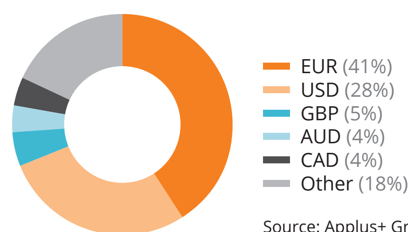
> ***We usually have a three-year moratorium on buying floats at Intelligent Investor, as it allows time for any skeletons to appear, but with Applus's share price falling so far there's already a decent margin of safety.***

That's left an Everest-sized quantity of Goodwill and intangible assets sitting aloft a large pile of debt. While interest costs are currently below 3%, the company has recently written off some assets and there's the possibility of more.

We usually have a three-year moratorium on buying floats at Intelligent Investor, as it allows time for any skeletons to appear, but with Applus's share price falling so far there's already a decent margin of safety.

Applus has diversified into the US and its currency exposure is broad (see Chart 3). Although currency fluctuations should wash out over time, they could hamper our returns in the short to medium term.

Chart 3: % Revenue by actual currency



Source: Applus+ Group Results Presentation, First Half 2014

Lastly, management gets paid well, but the potential value it could bank from options is egregious. It doesn't ruin our investment case, but it's definitely a black mark against the board and management.

Margin of safety

There's two ways to look at Applus's valuation. If we assume profits from newly constructed oil and gas projects fall 50% and stay flat forever, we'd get a price-earnings ratio for the stock of around 20. That seems fair for a company with multiple recurring revenue streams.

If we assume that revenues recover in a few years' time and the rest of the business enjoys a little bit of growth, perhaps as the Spanish economy recovers, then we could be buying the company on less than 10 times earnings compared to multiples of 20 or more for its rivals, such as US-listed company **Mistras**.

Donning our bullhorns, if Applus uses the current malaise to increase its market share by acquiring smaller or niche players at attractive prices the stock could double or more. Alternatively, Applus may be an attractive takeover target itself.

In the current environment you don't need to be creative to conjure disaster scenarios. But the most likely outcome for Applus is that earnings suffer over the next year or two before recovering as the oil price increases, rendering today's price too low.

We still want a large margin of safety, as things are likely to get worse before they get better, and unfortunately the stock price surged 9% last night. Still, we're initiating coverage with **BUY** up to €11 for up to 3% of a well-diversified portfolio. We'd likely only consider a higher portfolio limit once our investment case started working out.

*We're starting with a 2% position in the **Premium Portfolio**, leaving room to add to the position if the share price falls significantly. To do so, we're converting US$1,498.15 into €1,316.90 and purchasing 130 shares of Applus at €10.13 each.*