95/02-The Next Oil Boom

J.R. may be gone, but there are still opportunities to make a killing in oil--in the service companies

By Peter Lynch

It's hard to believe that more than a decade has passed since the heyday of Texas crude, when the Hunt brothers were riding high on the Forbes 400 list of richest Americans, Dallas was the world's most popular nighttime soap, the Arab sheikhs had bought up London, and everybody was scrambling to get into the "awl bidness."

All it took for the bidness to lose its glamour, besides Dallas going off the air, was a pesky decline in oil prices. This brought no joy to Rigville. The lower oil prices caused the Exxons and the Mobils to quit exploring for new sources, which left the drillers and the roust abouts with nothing much to do and a trail of bankruptcies and rusty rigs extended across several continents. The survivors have struggled along ever since, merging, cutting costs, and waiting for a new opportunity, which may soon open up.

We can't go much longer burning more and finding less. Lately, we've been living off oil fields discovered long ago--Prudhoe Bay and the North Sea--but these old supplies won't last forever. In fact, we're much closer to a shortage than the glut that people are worried about. You've read the stories: OPEC can't stick to its quotas, and once Iraq starts pumping, it will flood the market with 3 million extra barrels a day. What these stories don't mention is that with world consumption increasing by an annual 1.5 percent, each year we need another million barrels per day. At that rate, the Iraqi "flood" will be completely absorbed in three years' time.

It's the same story with natural gas: too many straws stuck in the drink. In the U.S., we're burning 20 trillion cubic feet a year, which is double the amount of new gas that's being discovered. The supply in the proven reservoirs has fallen from 290 trillion cubic feet in 1970 to 160 trillion cubic feet today. At the current burn rate, that's eight years' worth, which puts us as close to running on empty as we've been at any time in the second half of this century.

We continue to import from Canadian fields, but you can see where this is heading: More demand and less supply equal higher prices. So if you buy this scenario and you want to profit from it, you have two basic choices. You can invest in the oil producers: Exxon, Mobil, British Petroleum, et al. (Some of these stocks have had a decent run-up already, but there are still opportunities in the group, which I'll discuss in a separate column later in the year.) Or you can invest in the downtrodden oil-service companies that will benefit from the next pickup in drilling and exploration.

At that point, another kind of supply and demand will begin to work in favor of the oil-services outfits: the supply and demand for drills, bits, and rigs. The rig count, which is how oil hands keep track of this industry, has had quite a fall since1981, when there were 4,200 rigs operating in the U.S. and Canada and 1,400 in the rest of the world. Today, there are fewer than1,000 rigs at work in the U.S. and Canada and only 770 everyplace else. Very few industries have suffered a decline as severe as this one. In the

Gulf of Mexico and other watery locations, the offshore rigs have been vanishing at a rapid rate. They've almost become an endangered species.

The oil producers don't own rigs; they generally rent or lease them from the oil-service companies. So when they decide to start exploring again, they are going to be faced with a very tight market for rigs. This will be a fortunate situation for the owners of the rigs, who can raise the rents and name their price. They've already paid for the equipment, and it doesn't cost much to get it into shape, so the increased rent will pass through to the bottom line. That's why a slight pickup in drilling can be explosive for earnings.

But you can't just invest in oil services. You have to pick and choose among the land drillers, ocean drillers, pipeline operators, seismic mappers, downholers, rent-a-rigs, drill-bit manufacturers, tube makers, platform builders, and secondary-recovery companies. Oil services used to be a business in which muscles counted for more than brains, but lately it's gone high-tech. They've got 3-D seismic mapping. They've got new "smart" drills that go horizontal and can snake around the pathways and contours of the rock. They've got drill ships that can sink a probe in mid-ocean. They've got submersible rigs and semisubmersible pontoon vessels that float around like giant oil-sucking lily pads.

With their computer divisions, their science labs, and their Ph.D.s on the payroll, the most advanced of the oil-service companies have given up the he-man role to become technical advisors and consultants to the oil producers. In a sense, this sophistication hurts the old-fashioned drillers, because as the prospectors get smarter, they don't have to drill as many holes. The companies that have the brightest futures are those with the high-tech capability.

There's also been a lot of merger activity in the industry; thus, a handful of companies will dominate what used to be a fiercely competitive situation. The hulk in the lineup is Schlumberger, with annual revenues of $6 billion plus. Of the three analysts I contacted in researching this piece, two have put Schlumberger (NYSE: SLB) on their buy list.

Schlumberger executive vice president Victor Grijalva once admitted that the company had a King Kong complex, but that's been cured. The company let go of Fairchild Semiconductor, a conquest that was outside Schlumberger's regular line of work, and acquired a company in its own field, GeoQuest, a leader in seismic services that once belonged to Raytheon. Recently, Schlumberger has put its cash to better use, bought back stock, and managed to make money (more than $500 million after taxes in 1993) as the market for oil services has shrunk. It's not hard to imagine what will happen when the market begins to expand. The stock has been stuck in the $50–$70 range for several years, and lately it's fallen to the low end--$51 as of this writing. Analysts say it's going to go much higher, but even if it returns only to the top end, that's a 40 percent move.

Among various consolidations in progress, the one that looks the most promising to me is the upcoming merger between McDermott International's marine-construction division and a company called Offshore Pipelines. The result will be an entirely new company, J. Ray McDermott, which overnight will become the largest marine-construction outfit in the world. The parties to the merger were still awaiting final approval from the regulators when I wrote this, but the deal may have gone through by now.

If and when the merger is approved, James Stone at Werthheim Schroder predicts that the new company can cut $50 million in costs right off the bat, on the theory that two can live more cheaply than one. He estimates that cash flow will rise to $5 per share, and if he's right, we're about to witness an exciting development. Cash flow, simply put, is the money a company takes in. The normal ratio between the price of a stock and the cash flow of the company is about ten to one, but with Offshore stock selling at $20, the stock price to cash flow would be four to one.

You can approach this opportunity in one of three ways: buying shares now in McDermott (NYSE: MDR) or Offshore Pipelines (NYSE:OFP), or buying the new company, J. Ray McDermott. Stone thinks Offshore at around $20 is the better choice, assuming the merger hasn't happened yet. For each share of Offshore you own, you'll get a share in J. Ray, plus a 50 cent– per-share cash dividend thrown in as a bonus. James Carroll of Paine Webber favors buying the parent company, McDermott, which will continue to own 60 percent of the shares in J. Ray. He estimates that the J. Ray asset will be worth $12.50 a share to shareholders of McDermott.

Of the smaller, high-tech companies, Gordon Hall of CS First Boston recommends Western Atlas. It was spun off by Litton Industries in March 1994 at $40 per share, which is about where it sits now. Western Atlas (NYSE: WAI) is a leader in 3-D seismic services, which will be in great demand once the search for oil and gas begins in earnest. It's not cheap on earnings ($1.85 per share is estimated for 1995), but a cash flow of $5.45 makes it more attractive.

Finally, there's one I own: Tuboscope Vetco International. As you might have suspected, Tuboscope (Nasdaq: TUBO) is engaged in tubing and pipeline inspection. It's a specialized area, and not many companies are involved in it. At $6.50 a share, the company is cheap and attractive. It may earn 50 cents in 1995, which gives the stock a modest price-to-earnings ratio of 13. The estimated cash flow for 1995 is $1.35.

Last year, Tuboscope was almost bought out by Weatherford at $11 a share, and the company has announced it's still for sale. Somebody else could make a similar offer, but Tuboscope has a good chance of getting to $11 on its own.

But do your own research. Maybe you'll find some drillers you like. There are numerous companies in oil services that have gotten stronger and have sobered up considerably from the free-spending days. The ones that are making money now stand to make huge amounts when the price of gas and oil goes up. And if we get a burst of drilling activity and a rebound in seismic work and secondary recovery, we could see a heyday in oil services and a liftoff in these stocks to rival the liftoff in autos and chemicals that began in 1991.

Peter Lynch writes the Investor's Edge column with John Rothchild. Lynch is vice-chairman of Fidelity Management and Research and the coauthor, with Rothchild, of two books on investing. Beating the Street, the latest, is published by Simon & Schuster.