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Self-Service

By Peter Lynch

Gas prices are headed just one way. Get the difference back, and more, with oil company stocks.

In this space back in February 1995, I made a case for the possible revival of the oil-service companies—the drillers and rig operators that Wall Street had left in a scrap heap. It turned out that the survivors shook off the rust and ironed out the balance sheets—which was a pleasant surprise to investors in Schlumberger, Halliburton, Western Atlas, and some others. The analysts I talked to at the time were optimistic about energy services, and it looks like they had the right idea. Schlumberger has gained 62 percent in about 20 months. Western Atlas is up 40 percent. Shares of Global Marine have risen almost fourfold, to \$15 from \$4.

Now is a good time to deliver what I promised in that earlier column: a follow-up on the rest of the oil-and-gas industry, namely the refiners, the pure producers, and the integrations, which find, pump, refine, and sell oil and often do more besides. These three groups—which account for 90 percent of the oil business worldwide—include thousands of tiny companies with oily holes in the ground, plus the big names at the gas pump: Exxon, Mobil, Chevron, British Petroleum, Texaco, and Royal Dutch/Shell.

Oil is a timely subject on several counts, beginning with the current 3.8 percent dividend yield on the major oil stocks, which is nearly double the yield on the Standard & Poor's 500 Stock Index. (Dividend yield increases, of course, when a company raises its dividend more rapidly than the market bids up the stock price.) The relatively high yield in the sector is evidence that oil companies did not keep pace with the market in the past decade. This is the widest spread between oil yields and the S&P; yield in 45 years, suggesting either that oil companies are in lousy shape (which they aren't) or that Wall Street is giving them less credit than they deserve.

I'm reminded of the Baby Bells, which also lagged the market in the early 1990s and then had a nice rally. The parallels between the six Bells and the Six Sisters (the big names at the gas pump mentioned above) are intriguing. Both were created in antitrust breakups: AT&T; in 1984 and Standard Oil Trust in 1911. Both are widely held by individual investors and narrowly held by the pros at the institutions. In fact, only two of the Six Sisters appear in the top 20 holdings of equity mutual funds, according to the research firm CDA/Spectrum.

For this to become another example where the public is right, crude prices will have to rise from here. Just as there's no sense owning Kellogg's if you're bearish on cornflakes, there's no sense owning oil companies unless you're convinced that oil has a profitable future. On that subject, I'm not about to make any brash predictions, but I've begun to notice signs that the trend may be up—not for next month or next year, necessarily, but sometime before the Icelandic beach-volleyball team wins the gold medal.

On the demand side, you've got the commuters of the emerging nations driving more cars more often and developing an American appetite for high octane. Meanwhile, U.S. residents are holding up our end as the undefeated champs of gas guzzling. It seems like the 1970s all over again, with off-road vehicles as big as tanks and oxymoronic minivans filling the lanes where tiny Volkswagen Beetles once crawled.

The national speed limit was raised to 65 with hardly a peep from the energy-conservation faction, and this, along with the bigger cars and the widespread boredom with switching off the lights in empty rooms, will surely result in more barrels burned.

The daily world demand for oil now exceeds 70 million barrels, more than double the 31 million barrels a day we turned into heat, speed, and exhaust 30 years ago. More promising than that for oil investors, the annual rate of increase in demand has accelerated from 1.5 percent over the past decade to a projected 2.5 percent for the next two years.

There's no doubt the latest high-tech methods of drilling and exploring will capture oil in areas that were thought to be tapped out—it's already happening in parts of the North Sea and the Gulf of Mexico. But so far, the fancy probes with longer straws haven't produced enough oil to reverse an obvious and long-term decline: U.S. oil production peaked during the Nixon administration at ten million barrels a day. Today it's 6.5 million.

The price of oil went through the roof in the early 1970s, after the Arabs declared an embargo and stopped pumping. Adjusted for inflation, the price has gone nowhere since that expensive trauma. Because oil has been cheap all these years, people have begun to think we'll have cheap oil forever, the same way they thought the price would go up forever when it rose to \$40 a barrel during the embargo. As it turned out, their predictions of \$100 a barrel were completely off base, because the \$40 price stimulated so much production among suppliers and conservation among consumers that it's taken a quarter century for demand to catch up to supply.

Because the cycles are very long, it's easy to forget that oil and natural gas are cyclical commodities that move with the vagaries of supply and demand. Today, we've got tight supplies and low reserves in both oil and natural gas, while demand continues to grow.

Stock pickers have Saddam Hussein to thank for the bargains that can be found in the oil sector on Wall Street. The threat of Iraq's opening the valve on its big pipeline has been weighing on these shares since the Gulf War. For four years, investors have worried that the world will be glutted with oil and the price will collapse as soon as Saddam resumes pumping. But if Saddam had continued to pump at the prewar rate of 3.5 million barrels a day, they wouldn't be worried. Meanwhile, worldwide consumption has grown by two million to three million barrels a day since the war, so the increased demand has already sopped up Iraq's potential supply.

If you expect oil or gas prices to go higher and you want to take advantage of it in the stock market, there are two ways to proceed. You can invest in the giant integrated companies, such as the Six Sisters, or you can sink your assets into the smaller, so-called pure producers, of which nearly 300 are publicly traded. Both strategies have potential merit. Investing in the integrations is likely to be a safer bet with a more modest potential payoff. The pure producers are riskier, by and large, but they offer a more spectacular payoff if you invest in the right one.

The integrated companies are multinationals that work both ends of the pipeline, from the "upstream" wells and deposits through the refineries and neighborhood filling stations "downstream." And many of them have large petrochemical operations that at times produce substantial profits. Of the top 15 oil companies in the world, Exxon is the largest that's publicly traded.

The Six Sisters have reduced debt in recent years, and their dividend payout is a comfortable percentage of their cash flow. Their aggressive cost cutting enables them to make a profit on a lower price of oil. However, the strength of the Exxons and the Mobils is also their weakness. While their size and their clout protect them in hard times, they also hold these companies back when conditions are favorable. Mobil is a perfect example. Since it refines almost three times as much oil as it produces, Mobil is a buyer of oil as well as a seller, so a higher oil price doesn't automatically translate into higher earnings. What it gains selling oil downstream, it may lose buying oil upstream.

A more serious drag on Mobil's potential gain from higher oil prices is that it is also a chemical company. This helps when the chemical business is good, but lately it's been sluggish. Otherwise, Mobil and the other integrations might be doing better in the stock market, given the sharp rise in the price of oil.

You won't find either the pluses or the minuses of diversity with the pure producers. These companies work the upstream side of the pipeline, finding oil and then selling it. They run the gamut from low-budget operations with six employees, such as Bellwether Exploration, to midsize companies, such as Apache and Burlington Resources, which have around 2,000 employees each—still quite small when compared with Exxon's 90,000.

Unlike the integrations, pure producers can't be counted on to pay a steady dividend or even to stay in business if oil prices fall below the point where they can afford to pump it. But if oil prices take a jump, these stocks will tend to follow the same trajectory.

I contacted several top analysts who cover the integrations and the pure producers. Here are a few of their candidates for investment, starting with the small companies.

Mike Barbis at UBS touts Noble Affiliates (NYSE: NBL), based in Ardmore, Oklahoma. What he finds most attractive about Noble is that it owns more natural gas than oil; Barbis is more optimistic about natural-gas prices than oil prices. Noble earned 35 cents a share in 1995, and Barbis expects it to earn \$1.50 this year and \$2.05 in 1997. He also likes Louisiana Land and Exploration (NYSE: LLX), which has cut its production costs for oil from \$9.27 a barrel to \$7.20. Jim Clark at CS First Boston likes a Texas refiner called Valero Energy (NYSE: VLO).

Many pure producers are found in Canada. Martin Molyneaux at FirstEnergy in Alberta likes Canadian Occidental Petroleum (AMEX: CXY), a subsidiary of U.S.-based Occidental Petroleum. Among smaller companies, he likes Alberta Energy (NYSE: AOG) and Renaissance Energy (Toronto: RES).

Of the big companies, Michael Mayer from Schroder Wertheim likes Mobil (NYSE: MOB) and Texaco (NYSE: TX), to which he has assigned target share prices of \$127 and \$94, respectively—bumps of 14 percent and 9 percent from where the stocks are trading as I write. Jim Clark likes Unocal (NYSE: UCL) at its current price of around \$34 a share. He's also recommending Texaco and Chevron (NYSE: CHV). He sees a jump in Texaco's earnings from \$3.90 a share in 1995 to \$5.55 in 1996 and \$6.10 in 1997. Other analysts are projecting similar jumps for many companies in the oil group.

Remember my mention of the underweighting of these stocks among institutions? If good earnings reports convince institutional buyers that they've been wrong about oil, they'll rush in to buy. That will be nice for the individual investors who get there before the big players do.

And there's one more potential attraction to the integrateds: They may add ballast to a portfolio, because oil companies often thrive on bad news, such as wars. The oil embargo of the 1970s was a shock that seemed to come out of nowhere. Who knows where the next disruption could arise: a revolution in Saudi Arabia, a shutdown of the Soviet oil fields, an uprising in Venezuela? An oil crisis could even result when Japan or Germany emerges from its economic woes. It would take a shortage of no more than a million barrels a day to produce another shock in which oil and gas stocks would likely go up while most stocks were going down.

Peter Lynch writes "Investor's Edge" with John Rothchild and is vice- chairman of Fidelity Management and Research. Their third book, Learn to Earn, was recently published by Simon & Schuster.