

Focal Point

Energy sector: in the midst of a re-rating trend

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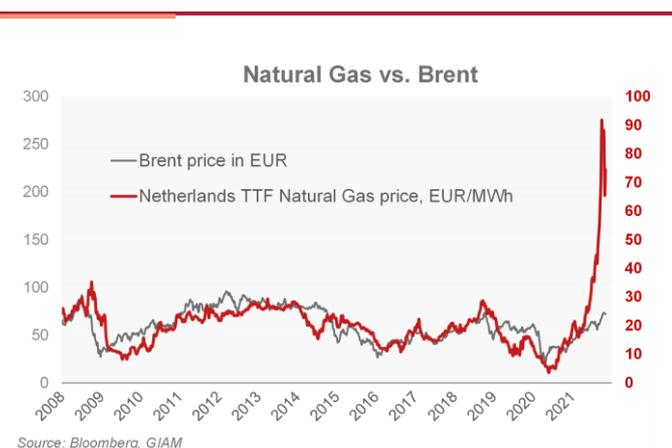
Our *Focal Point* series explores topical issues on macro, markets and investment

Since last spring, the surge in gas prices has ignited inflation fears and harmed energy-sensitive industries. While pressures have subsequently eased, the spike highlighted the risks related to an unstable demand supply-equilibrium.

Several factors, some temporary, are behind the spike in prices. Fundamentally, the Green transition creates short-term uncertainty, as years of underinvestment in fossil fuels make it difficult for supply to adapt to large increases in demand.

We remain bullish on Energy credit as the industry performs very well with high inflation and relatively high oil prices (Brent should end 2022 in the 75 to 80 US\$/bbl range). High fixed costs are easier to absorb as cash flows accelerate (high operating leverage), leading to higher dividends, renewed share buybacks and debt reduction. That said, the spread trajectory will remain overall constrained by the poor ESG profile of the sector (albeit improving). Dispersion between ESG winners and losers should increase further.

Concerning Equities, Energy – a Value sector – benefits from sticky high oil prices, higher yields and the prospects of continued solid demand growth. Moreover, very low relative valuations and increasing greening initiatives allow us to keep an OW position. We have however trimmed it after the big rally, as quant models signal overbought conditions.



The unprecedented spike in gas prices is adding to woes about the risk that high inflation may derail the EU recovery. The direct impact on CPI inflation, which is cushioned by fiscal measures in some countries, will add to the sharp increase in non-labour costs in several energy-intensive sectors, like steel and paper. In this Focal Point, we sketch the temporary and more structural factors behind this increase and highlight the constructive implications for Energy credit and equities.

Temporary factors include weather conditions that have limited power generation from renewables (wind and

hydropower) in Northern Europe. Moreover, global gas demand has ticked up as China tries to move away from coal. On the supply side, Russia has been reluctant to increase supply, pending the approval of the new Nord Stream 2 pipeline by the German and European regulators. The pipeline might not be approved by May if regulators go down to the wire. At the end of October, signals of a commitment by Russia to increase exports to Europe led the gas price to pull back considerably and futures on gas prices now feature a strong backwardation. But a cold winter ahead represents a concrete risk of further spikes in energy prices.

Structural factors are also preventing higher supply: it is impossible in the short term to diversify the sources, e.g. increasing imports of liquified gas from the US. And the EU emission regulation makes it extremely costly to temporarily switch to available “brown” sources, like coal.

Gas shortages add upward pressure on oil prices

Switching to oil to cushion the impact of high gas prices offers limited relief. In the US, only less than 20% of gas usage for electricity can be shifted to oil. Still, extra demand has supported further upward pressure on oil prices, adding to those from OPEC+ constrained supply growth. Contrary to the past, output from US shale producers is lagging relative to the rise in prices. Stretched balance sheets, insufficient returns on capital have led to under-investment over the past years. Resources have swiftly moved away from oil towards renewables. As a result, the number of rigs that can be activated quickly dropped. Moreover, uncertainty on climate regulation limits willingness to invest, further hampering capital inflows. This will cap the size of the slide in oil prices determined by the cooling of demand (especially in China) and the gradual increase in supply. The Brent should end 2022 in the 75 to 80 US\$/bbl range, a bit above the 75 US\$/bb futures are signalling. Risks are tilted to the upside given the strong discipline showed by OPEC+ members and the volatility related to a choppy transition to renewables the gas crisis highlighted.

“Green” transition creates short term uncertainty

Coping with climate changes pledges entails a more than doubling in the share of renewables in energy consumption. Storage capacity is still limited, which reduces the possibility to cushion volatile energy production from renewables. In principle, the transition would be eased by a higher reliance on gas and nuclear power. But the former suffers from underinvestment; both are also politically contentious, as shown by the prolonged spat over the decision to include nuclear and gas in the EU taxonomy of green energy sources. Markets will thus price the risk of disruptions in renewable production as a factor making the price of “brown” fuels more volatile. Indeed the strong backwardation in fossil fuels’ price curve reflects the belief that the gas shock was an one-off and that both gas and oil prices will drift down as competition from renewables intensifies due to decreasing production costs and tighter environmental regulation. Yet this is based on the strong assumption that the supply of energy from renewables will stage a fast and smooth expansion over the coming years. Should this prove too optimistic, market repricing could be harsh.

The EU sectors credit fundamentals: a mixed impact

Our macro scenario sees persistent but partly receding inflation pressure, and resilient economic growth. Therefore, the credit fundamentals of our coverage have not changed much, but the impact of lingering high cost inflation varies across sectors.

Industrials: Materials, Metals and Mining will benefit from higher commodity prices. Cost inflation will instead negatively impact basic chemicals’ profitability. For Building Materials, cement producers’ earnings will be hit the most, while Capital Goods and Transportation will prove more resilient.

Consumers: For Autos, OEMs (Original Equipment Manufacturers) are better positioned than suppliers thanks to shift in volume mix towards premium models. Durables, apparel and non-food retail are expected to be negatively impacted by the increased commodity prices since H1 2021, while for Staples we do not see meaningful credit deterioration.

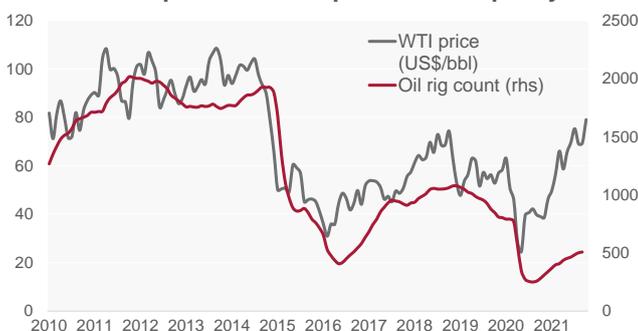
Healthcare: Inflation alone will not trigger rating actions. In that space, MedTech, hospital suppliers, and healthcare operators are expected to be the most impacted.

Real Estate: Limited direct exposure of letting businesses to inflation risks thanks to indexation. Property developers are more exposed.

Telecoms: Neutral near-term direct impact from commodities (5% of operating costs). A possible increase in wages could be more material (30% of operating costs).

To sum up, **metals, international oil companies, oil service firms and property letting businesses (ex-retail)**

Oil prices and US productive capacity



Source:Refinitiv

are positively exposed to increased cost inflation. On the contrary, **non-food retail, building materials, mass-market OEMs and OEMs suppliers are negatively exposed.**

Positive	Neutral	Slightly Negative	Negative
Metals & Mining	Telecoms	Food Retail	Non-Food Retail
EU IOCs	Food, Beverage, HPC	Cons. Durables & Apparel	Building Materials
Oil Serv. Companies	Tobacco	Low quality NOCs	Mass-market OEMs
Property Letting	Airports/Toll Roads	Chemicals	OEM Suppliers
	Healthcare	Mass Transit/Rail	
	Utilities	Postal Operators	
	Top quality NOCs	Capital Goods	
	US IOCs	Premium OEMs	
	Retail RE companies	Tire manufacturers	
		Property developers	

Energy credit sector view: remain constructive

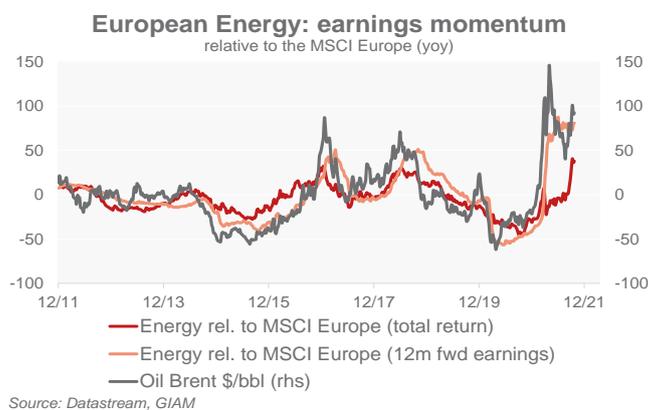
Energy companies benefit from a high cost-inflation environment. We prefer **European International Oil Companies (IOCs) vs. National Oil Companies (NOCs)**. Low impact for Utilities is due to diversified business, higher wholesale prices for power generation and positive impact on regulatory returns driven by increased inflation.

In a rising oil price environment, the industry benefits from high fixed costs (high operating leverage) and high albeit rather stable volumes.

a premium versus similarly rated sectors. We suspect this pressure on "dirty" sectors will increase over the coming months as the ECB will integrate climate criteria into its credit purchases. We also **expect the dispersion between the most and the least advanced players in terms of energy transition to increase further**, meaning doing the homework on ESG is key to secure performance going forward.

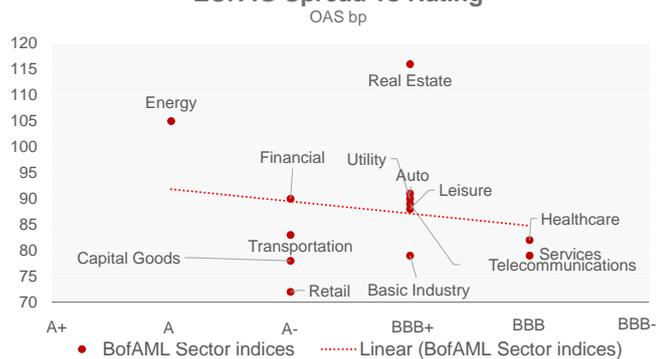
Equity sector view: we keep a cautious OW

Oils represent one of the few natural hedges versus inflation and commodity spikes and the low correlation with long-term rates makes it less sensitive to higher yields. The chart below shows that the relative performance of the energy sector versus the MSCI Europe is the most positively correlated to inflation changes among EU sectors.



Source: Datastream, GIAM

EUR IG Spread vs Rating



Source: Bloomberg, BofAML indices, GIAM own calculations

Following a strong and increasing cash flow generation and reinstatement of share buybacks in Q2/21, we expect further acceleration of cash flow/profitability in H2/21 that will easily finance capex plans (shift towards renewables), dividends, additional share buyback and debt reduction.

Rising input costs are a minor headwind due to efficiency gains achieved in the last years and will only partially offset the remaining positive drivers.

Oil servicing companies would also be positively impacted by i) necessity to maintain/increase capex from IOCs/NOCs (int. oil companies/national oil companies) on upstream and ii) big pipeline of renewable investments.

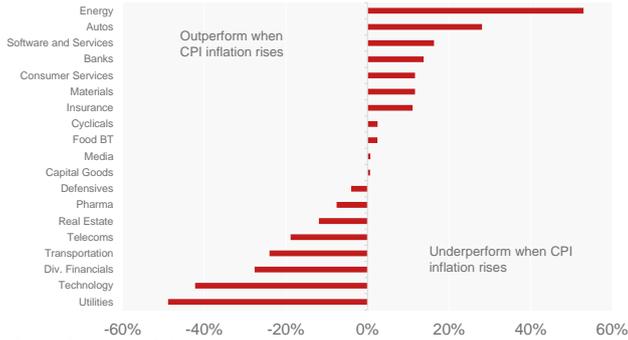
Nonetheless, the positive effect on profitability might not directly translate in the spreads as much as it did in the past. Indeed, the poor ESG profile of the sector is already implying

Since the beginning of the year, the EU energy sector has posted a total return of 44%, double that of the MSCI EU. 12-month forward earnings have been revised up by 115% vs. "just" 30% for the whole index. In total returns terms vs. MSCI Europe, the sector still lies 60% below the 2009/2010 and 40% below Jan. 2003 earnings levels. This is due to both poorer earnings trends and the recent investors' allergy to low ESG scores.

Current earnings revisions are still near a cyclical high (Q3 reporting season is showing higher surprises vs the index for the sector) and could roll over in part, as the oil price should stop rising in the coming months (as we expect). Thankfully, the Oil sector enjoys manageable debt positions and high free cash flow as well dividend yields. As the macro trend stays firm (albeit less exuberant) and bond yields's trend is tilted to the upside, we expect the Value style – not least banks and energy – to continue to outperform.

Sector sensitivity to European inflation

correlation using yoy data since 2010



Source: Datastream, GIAM calculations

Longer-term, oil firms are taking action towards a greening of their activities. While this is a slow process, such move should in time bring improvement in their ESG scores – at least those of the fast movers. This will contribute to reducing the gap between increasing oil prices and stagnating oil stocks' relative performance.

Our quant (macro-based) models showed deep undervaluation in August; but after the +20% relative price move since then, they have turned much less upbeat and

have started to signal some overbuying. Moreover, peaking confidence indicators (ISM, IFO, PMI manufacturing etc.) could also limit the sector performance in the short term. For these reasons we decided to reduce our OW on the sector. On the other side, several valuation metrics (i.e. market multiples, Shiller CAPE, total return based on earnings growth and dividend yield) suggest the energy sector remains deeply undervalued on a mid-term basis, effectively one of the cheapest within the 18 sectors we follow in Europe.

Sectors	PE		PB		PCF		DY		Avg. Discount, %	PEG adj. *
	12m f	Discount								
Europe	15.6	18.7	2.0	17.7	9.6	24.0	3.0	-19.6	20.0	1.3
Auto and Components	7.4	-42.2	1.0	-3.2	4.2	1.6	4.2	25.1	-17.2	1.0
Banks	9.5	-5.7	0.7	-29.4	5.8	8.7	5.2	4.1	-7.6	1.6
Capital Goods	20.6	38.3	3.5	50.9	14.3	46.7	2.2	-29.5	41.3	1.4
Commercial/Prof.Services	24.5	44.8	7.6	74.6	17.6	47.9	2.1	-23.9	47.8	2.1
Consumer Durables & Apparel	24.8	46.2	3.9	56.0	16.1	28.7	1.9	-20.3	37.8	1.3
Consumer Services	31.7	81.7	3.9	40.1	19.3	79.0	1.5	-51.7	63.1	1.9
Diversified Financials	13.0	14.5	1.2	-1.0	7.4	-7.7	2.4	-31.8	9.4	1.8
Energy	9.0	-21.2	1.2	-20.6	4.0	-25.7	4.6	-7.6	-15.0	0.7
Food and Staples Retailing	16.1	16.4	1.9	7.8	7.1	7.3	3.1	-6.5	9.5	1.6
Food, Beverages and Tobacco	20.3	18.9	3.5	5.3	15.6	20.5	2.8	-11.9	14.2	2.2
Health Care Equip. and Services	26.3	32.6	3.2	9.6	16.6	26.6	1.3	-16.9	21.4	1.8
Household and Pers. Products	22.1	14.4	5.1	29.7	17.4	12.3	2.6	9.3	11.8	3.6
Insurance	10.8	12.2	1.1	-3.6	8.8	-69.3	5.1	4.6	-16.3	1.2
Materials	11.7	-9.1	2.0	21.2	7.7	6.5	4.4	35.7	-4.3	1.3
Media	20.2	30.3	2.0	-15.9	12.8	44.4	2.1	-45.3	26.0	1.9
Pharmaceuticals, Biotech. and LS	17.3	18.6	4.0	18.7	15.3	27.1	2.6	-21.8	21.6	2.0
Real Estate	19.7	8.2	0.9	-1.2	18.9	17.4	3.0	-30.6	13.8	4.3
Retailing	29.1	59.2	3.4	8.6	30.3	138.0	1.2	-64.9	67.7	1.5
Semis	36.0	35.7	10.7	241.8	29.5	124.8	0.6	-43.1	111.3	1.5
Software and Services	30.8	60.9	5.0	44.2	24.6	58.6	1.0	-40.8	51.1	2.5
Tech. Hardware and Equipment	19.4	15.2	3.1	34.1	15.5	20.2	1.6	-41.8	27.8	2.3
Telecommunication Services	14.0	-28.8	1.3	-16.5	3.4	-25.4	5.0	-9.1	-15.4	3.0
Transportation	16.3	8.5	3.2	62.8	8.1	20.3	3.0	-5.4	24.3	1.3
Utilities	15.8	19.5	1.9	16.3	6.6	11.9	4.6	-11.4	14.8	3.4

Note: Discount in % to long-run norm; 12m f = expected in 12 months. Multiples are since 2004. In case of DY, a discount means the market had a higher DY, meaning the market is at premium for this multiple.

PEG adj. (higher = expensive): PEG (12m fwd PE / earnings growth over 2-5 yrs) is modified by the ratio COE/ROE, which signals the ability to produce a return on capital higher than the cost of it. COE = cost of equity = 10yr gov't bond rate + 8% mkt risk premium x country Beta versus MSCI WORLD (monthly returns over the last 10 yrs).

Source: Thomson Reuters Datastream, IBES estimates.

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