

Oil Stocks to Buy: A Preference for Profits Over Promises

We believe investors should be open-minded about old-fashioned energy for two reasons. **First**, we have a growing conviction in oil companies' capital discipline. **Second**, while commodity prices **may** rise due to severe [underinvestment](#), they do not need to for the sector to become a massive profit engine for investors.

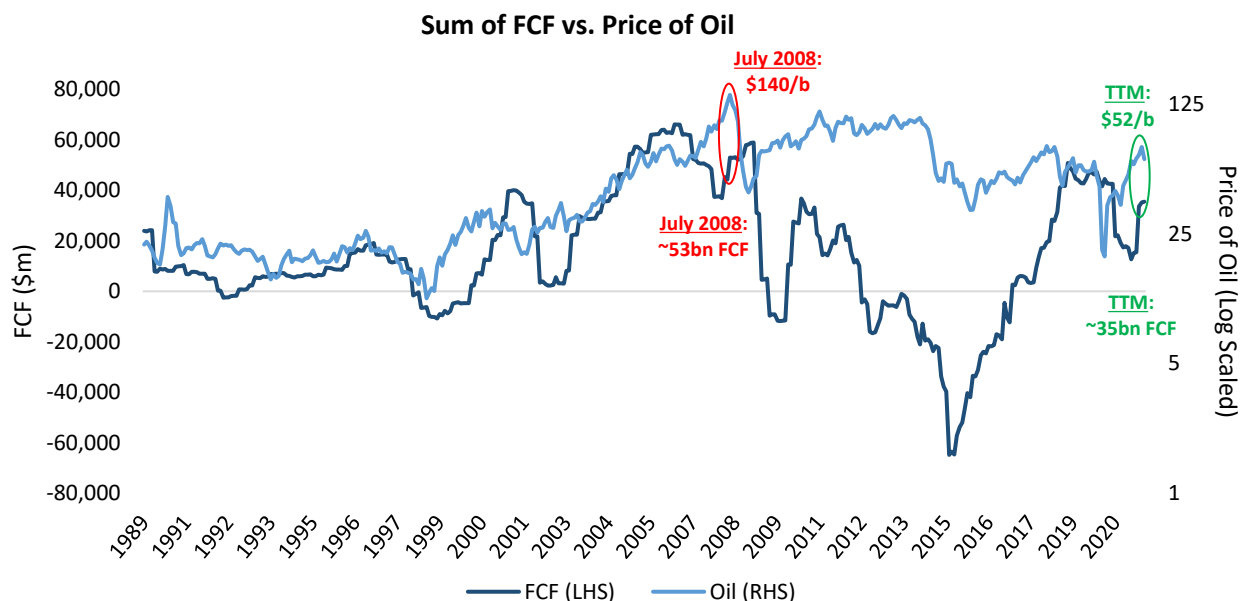
Consider:

- On March 29th, 2020, we published a [study](#) on sector responses in crashes. With oil at negative prices, energy stocks down 61%, and industry consolidation underway, we believed that survivors of the carnage were a "...call option on the eventual resumption of even partially normal human behavior."
- In April 2020, we published an [update](#) noting that with total stimulus exceeding 30% of GDP, despite elevated valuations, stock selection would be key to strong performance.
- In March of 2021, we published a study of the [Great Inflation of the 1970s](#) which showed that not only had Energy & Staples been some of the biggest beneficiaries of inflation, but that **the market's valuation structure was such that many popular sectors were priced like long term inflation was impossible**. Watch our follow-up presentation on equity duration [here](#).
- Since then we have written pieces that discussed the [bubble](#) in renewable energy companies, a [piece](#) explaining that ESG and brutal capital destruction were setting energy up for the virtuous cycle of capital discipline, rising free cash flow, deleveraging, multiple expansion, and healthy dividend yields.
- A [piece discussing](#) soaring food prices due to drought and rising energy costs as well as a [piece](#) showing that magazine covers were giving their classic contrarian **buy** signal and showing energy has the lowest weight in the S&P 500's history.

Fig. 1 below is at the heart of our **first point of conviction** – oil prices do **not** need to rise for energy stocks to see explosive growth in **profits**. **When oil peaked at \$140/b, the sector generated \$53bn in FCF**. The energy sector today has generated **\$35bn** in FCF in the trailing 12-months, with oil at an average price of **\$52**. This means, energy stocks are generating ~70% of the FCF despite oil prices being 63% lower than the prior peak.

This is simple and powerful evidence of the importance of capital discipline to overall sector profits.

Fig. 1: Energy Generates 70% of the Profits Seen at Peak Oil Despite Oil Being 63% Lower



Source: Kailash Capital, LLC; Data from 12/31/1989-7/31/2021 *Last oil price as of 8/19/2021

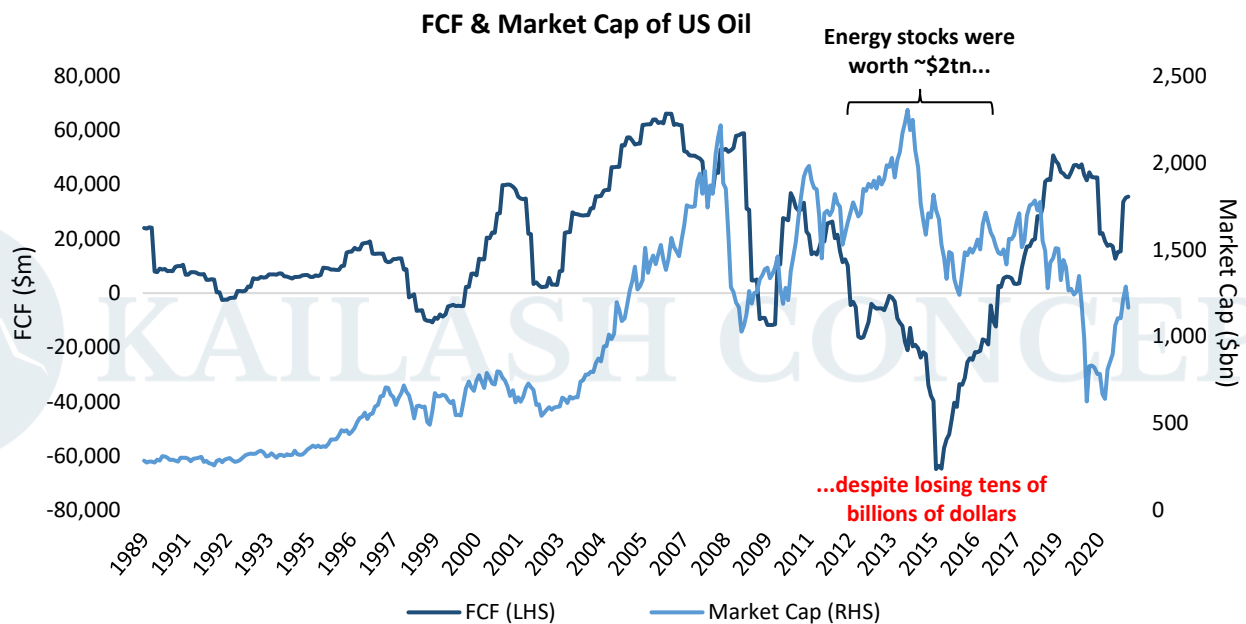
This is why the KCR team has such deep roots in data-driven behavioral finance. The below chart shows how narrative can trump facts and profits for only so long. The navy blue line is still the energy sector’s FCF. But the light blue line is now the aggregate market cap of energy companies.

Incredibly, the market cap of oil companies hit \$2tn+ during the loss-making years after the oil price peaked in 2007 despite losing tens of billions of dollars! If that looks ridiculous, we would agree. Today, the inverse is happening. With the narrative around peak demand due to battery electric vehicles, solar energy, and other novel tech ideas becoming a consensus, oil stocks are valued at just over \$1tn despite healthy profits.

We believe the millions of people chasing these “exponential return” companies will end up being burned by valuations as extreme as those at the peak of the dot.com bubble. The quest for revenue growth underway today has resulted in bubble valuations of firms that make grand promises around energy transformation.

In sharp contrast, today, oil makes almost record profits due to capital discipline. Yet sentiment is as negative as any time we can recall in our history. The very discipline creating today’s profit boom may also be the genesis of another massive rally in oil prices, in our view.

Fig. 2: The Mismatch Between Profits & Market Cap Screams for Investor Attention Today



Source: Kailash Capital, LLC; Data from 12/31/1989-7/31/2021

We would like to remind our readers that the \$35bn in FCF was generated with oil prices at \$52 in the trailing 12-months through 6/30/2021. So far, from 6/30/2021 to 09/07/2021, oil’s average price has been \$70. Despite this, energy is down 10% while the market has risen 5%.

Our team’s lack of specialization in energy, something we have reiterated ad nauseum over the last year, has helped us see the forest and avoid the trees since the Covid crash. We believe the chart below is another example of “generalist” thinking being a powerful ally in energy stock analysis. Our team does not have the skills to build out complex models that attempt to estimate the volume of every company’s wells, the costs of F&D, or the timing of these flows.

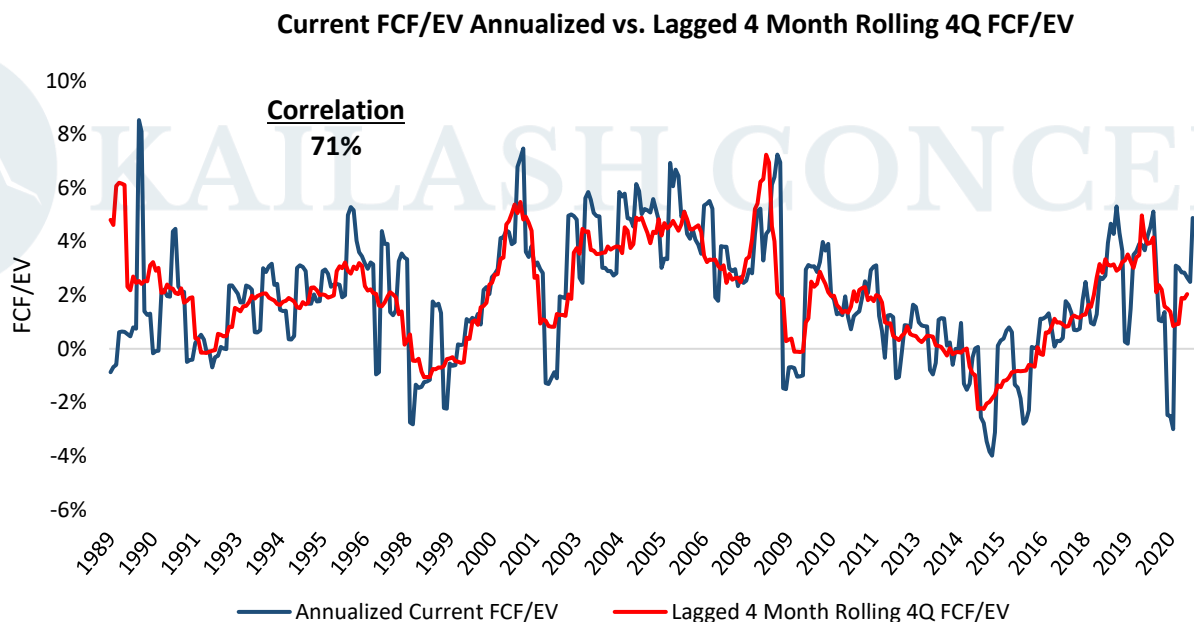
We recognize there may be tremendous utility in such endeavors for others and are in no way discounting such diligence. We are simply a team that looks at the past to help bring context to the present. The chart below is our attempt to simplify the complex and bring focus where there is often controversy.

The **navy blue line** is the FCF yield of the Energy Sector if you simply **annualize** the most recent quarter’s FCF. The **red line** is the actual trailing four-quarter FCF yield of the sector lagged by four quarters. Some may cry “autocorrelation.”

Our view is this confirms the long-held belief that nobody can predict oil prices, much less profits. But in the short run, the **trend is very much your friend** when it comes to the intersection of oil price and capital efficiency in the Energy sector.

If you don’t believe that the \$35bn in FCF shown above will continue to rise, you are betting that the red line below will stray from the blue going forward – something that has never happened in 30 years. On the next page, we will explain why this is bullish today.

Fig. 3: The Current Run Rate of FCFs has been an Incredible Predictor of Future Yields & is BULLISH



Source: Kailash Capital, LLC; Data from 6/30/1989-7/31/2021

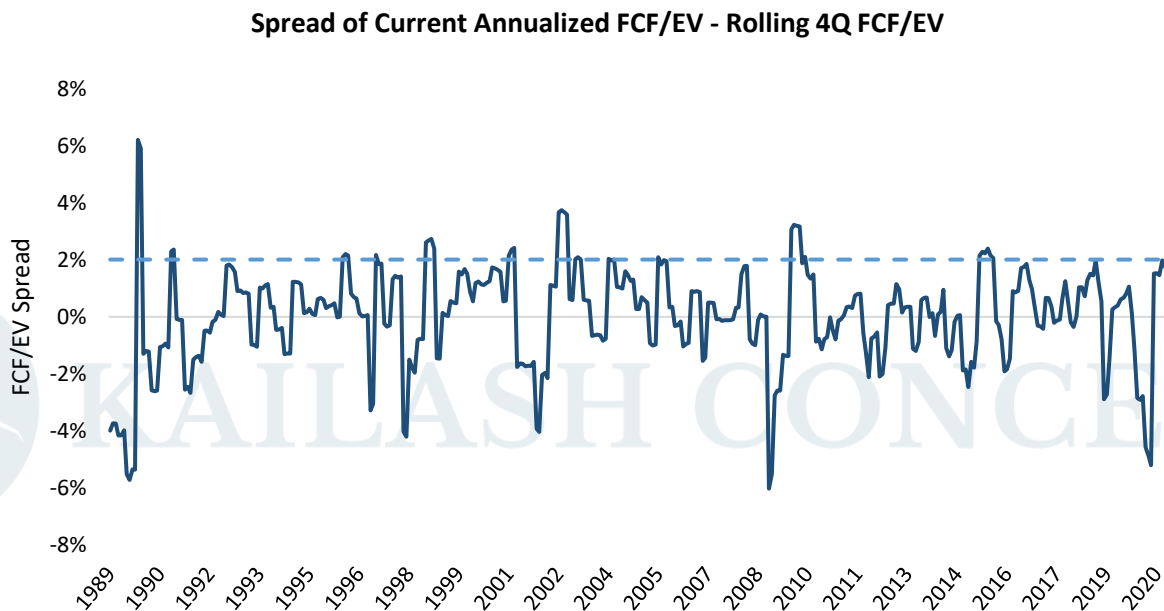
Energy Stocks To Buy & The Reason Why

Our team would note that the Q3 average price of oil is currently at \$62, a 20% increase over the average price in the trailing four quarters. We believe capital discipline will remain firm, and the increase in oil prices could translate into much higher FCF than the \$35bn in the trailing four quarters.

Figure 4 below plots the spread between the red line and the navy blue line above. It shows the spread between the FCF yield of the energy sector using the most recent quarter annualized and the actual trailing four-quarter FCF yield of the energy sector.

Spreads today are at the widest levels in over 30 years of history. The market is effectively pricing in a very low chance that the FCFs being generated today are likely to persist. We believe this may be another incredibly bullish signal.

Fig. 4: The Spread Between Annualized Current Quarter FCF and TTM FCF is at Record Wides



Source: Kailash Capital, LLC; Data from 6/30/1989-7/31/2021

We recognize that fans of forecasting are not going to like this type of analysis. Our team has and continues to endorse the facts available while avoiding making investments based on analyst ratings and forecasts. This is particularly true when the forecasts represent overwhelming consensus as they do today.

Let's look at XOM, the stock that just got kicked out of the Dow Index after almost 100 years as a constituent. Bloomberg wrote about that in an article titled "[Exxon Booted from Dow Industrials in Major Embrace of Tech](#)" – could there be a more contrarian signal? The most bearish analyst on Exxon is [redacted¹]. Incredibly, this firm's SELL recommendation has a price target that is 20% higher than the current stock price. There are 9 "BUYS," 20 "HOLDS" and 1 "SELL."

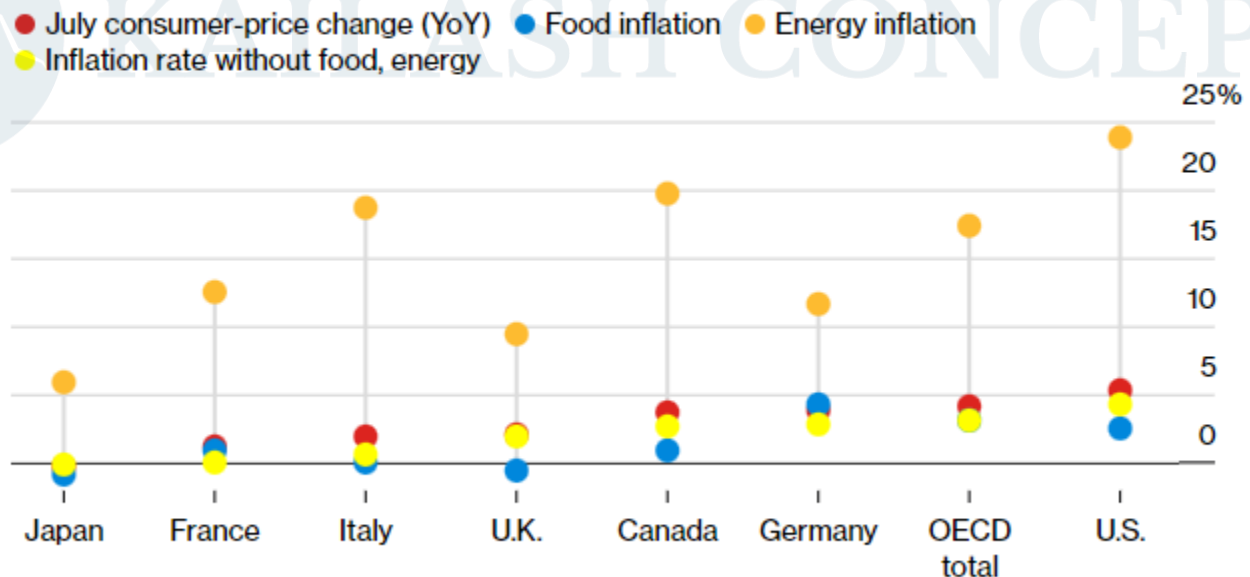
Consensus earnings for this year on the stock are \$4.31 with 2022 penciled in at \$4.80 per share. What are the oil price assumptions in those estimates? That puts the stock at 11x earnings with a 6.3% dividend that FCF fully covers. The world is awash in outlandish valuations on stocks that are in "green tech" and often make no money. Yet, the very core of human civilization, energy, is priced as if we no longer need it.

As we will discuss in an upcoming piece reviewing some of the best science in the space, the world still very-much relies on oil no matter what our views on climate change might be. **Hopefully, you can forgive us for wondering: could energy stocks be the cold, harsh reminder to capital markets that cash flow is ultimately king? That paying obscene multiples for future promises has almost always led to disaster?**

Fig. 5: Despite Rampant Increases in Energy Prices, The Market is Bearish on Energy Stocks

Price Pressure

Energy inflation is soaring across G-7 economies



Source: Organization for Economic Cooperation and Development

Source: Bloomberg News; <https://www.bloomberg.com/news/articles/2021-09-04/global-gas-price-surge-threatens-to-dent-the-economic-recovery>

¹ Check the ANR feature in Bloomberg For Institutional Use Only

Figure 6 below shows how betting on the energy stocks with the widest spreads between their most recent quarter’s annualized FCF yield to trailing four-quarter FCF yield pans out when the sector is in the top decile of spreads.

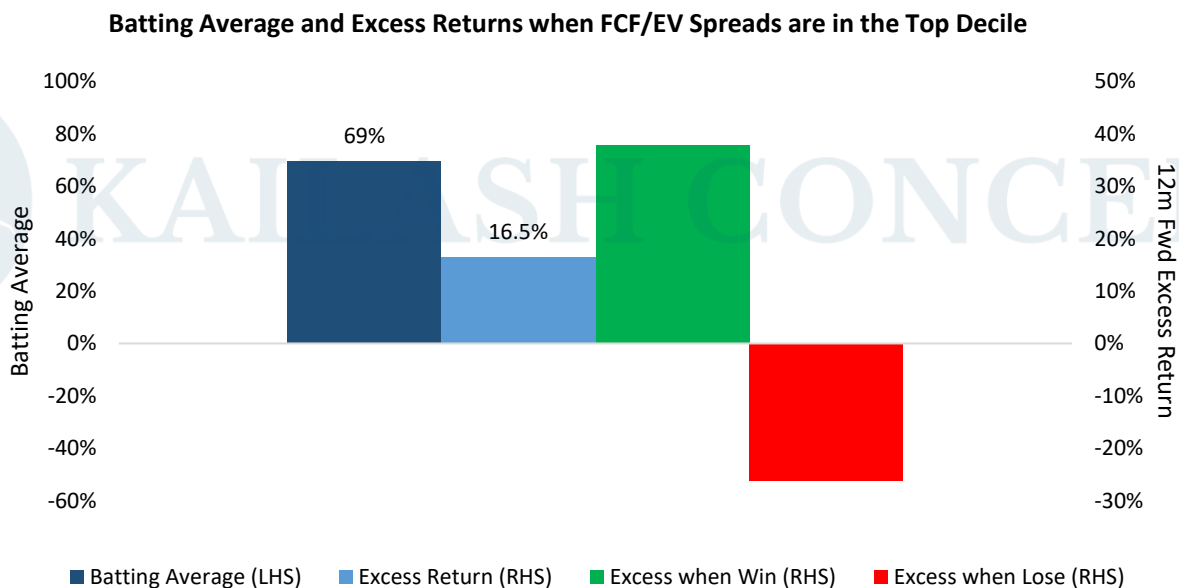
Figure 6 below shows the **batting average**, **average excess return**, excess return when you **win**, and when you **lose** if you:

- Waited to invest in energy stocks until the sector’s trailing one quarter FCF Yield was in the top decile of spreads with its trailing four quarters FCF Yield (waited until the sector spreads were above the dashed line in Fig. 4 above)
- And only invested in the 10% of stocks during those times with the widest spreads

To us, this foots perfectly with intuition. This method of energy investing is the behavioral equivalent of waiting until the market had the least faith in the most recent quarter vs. the trailing four quarters and then, in those times, finding the stocks people were the most pessimistic on.

The results are impressive as the batting averages and payoffs have been outsized. **We are there today.**

Fig. 6: Betting on the Energy Firms with the Widest FCF Yield Spreads in Times Like Today



Source: Kailash Capital, LLC; Data from 6/30/1989-7/31/2021

Conclusion & A List of Oil Stocks We Like:

Our work leans heavily on the experience of others far wiser than us. As we noted in our review of John Kenneth Galbraith's [study of bubbles](#), *Human beings mistakenly associate quick riches with intelligence and are more willing to discard common sense and follow suddenly wealthy individuals who often tread outside the law.*

We fear today's "prophets" will be felled by facts and the ruthless act of economic gravity that has wiped out speculators in every period like today since records were kept. KCR presents figure 7 to drive our point home in a simple table. The table shows data for the S&P Energy ETF and two popular "green energy" ETFs:

1. **Current FCF/EV:** This is the most recent quarter's FCF annualized for all three instruments
2. **FCF/EV:** The actual trailing four-quarter FCF/EV
3. **Valuation:** Price to Sales (P/S), Price to Earnings (P/E), and Price to Book (P/B)
4. **Quality:** The aggregate ROE, EBITDA margins, and Total Yield, which is dividends + net (issuance) repurchases

Hopefully, the point jumps off the page for you as it does us: old-fashioned energy has booming FCF, trades at a 50% discount to the novel & new clean energy stocks based on P/S and P/B, while sporting positive margins and yields that are 4x higher than 10-year treasury yields.

We believe old-fashioned energy, which is still very much the backbone of our global economy, is dirt cheap when compared to the cash incinerating firms in the "clean energy" space.

Fig. 7: Fundamentals of "Old" Energy vs. "New" Energy

	Current		P/S	P/E	P/B	ROE	EBITDA Margins	Total Yield	ROA
	FCF/EV	FCF/EV							
XLE ETF	9%	5%	1x	Neg	2x	-1%	20%	5%	0%
PBW Clean Energy ETF	-3%	-3%	2x	Neg	3x	-2%	-230%	-8%	-2%
QCLN Clean Energy ETF	0%	0%	5x	138x	5x	5%	-1%	-5%	2%

Source: Kailash Capital, LLC, Bloomberg; Data from 8/31/2021 *We were able to match on 87% of PBW holdings and 96% of QCLN

Where could we be wrong? Well, this is oil, so we could be wrong in many places for many reasons. We want to close with the following clarifications:

1. We believe another surge in Covid could hammer demand, oil, and energy stocks but believe it will only exacerbate the dire reductions in investment and should be viewed as an opportunity
2. We believe that if oil prices decline sharply due to a global economic slowdown, that would indicate a contraction in global liquidity and central-bank largess, and the penalties for investors in speculative stocks would dwarf the losses in energy stocks, in our view
3. We believe that despite soaring geopolitical stresses, the market has priced in nearly zero chance for any interruption in global energy supplies and
4. The price of energy stocks and their record low weight in the index, as documented in our [recent chart](#), indicates these stocks are very cheap call options on any possible inflation

Please find below the stocks that have the widest annualized 1 quarter FCF/EV spread to their trailing 4 quarter FCF/EV. If the past is precedent, this may be a terrific time for us all to do our homework on these and other energy names.

Exhibit

Exhibit 1: Energy Stocks with Top Decile FCF/EV Spreads Current vs. Rolling 4Q

Ticker	Company Name	Current	
		FCF/EV	FCF/EV
COP	CONOCOPHILLIPS	14.3%	5.0%
DK	DELEK US HOLDINGS INC	10.6%	0.3%
GPOR	GULFPORT ENERGY CORP	0.3%	-8.3%
HFC	HOLLYFRONTIER CORP	13.2%	1.4%
MGY	MAGNOLIA OIL & GAS CORP	18.2%	9.8%
MUR	MURPHY OIL CORP	14.7%	5.9%
OXY	OCCIDENTAL PETROLEUM CORP	18.6%	7.7%
PARR	PAR PACIFIC HOLDINGS INC	5.9%	-6.4%
PSX	PHILLIPS 66	12.3%	3.1%
TALO	TALOS ENERGY INC	14.2%	-1.2%
VLO	VALERO ENERGY CORP	17.3%	1.6%
WLL	WHITING PETROLEUM CORP	24.3%	15.8%

Source: Kailash Capital, LLC; Data from 8/31/2021

Appendix

Item 1: oil generated \$35bn in FCF with oil at \$52, oil price below:

CL1 COMB Comdty		Export	Settings		Page 1/6	Historical Price Table	
Generic 1st 'CL' Future							
Range	06/30/2020	-	06/30/2021	Period	Daily	High	74.05 on 06/25/21
Market	Last Price		Volume	Currency	USD	Low	35.79 on 10/30/20
View	Price Table					Average	51.84 348,485
						Net Chg	34.20 87.09%
Date	Last Price	Volume	Date	Last Price	Volume	Date	Last Price

Item 2: current quarter, Q3 of 2021, average oil price is at \$70 or ~\$20 higher than the trailing 12 months average oil price.

CL1 COMB Comdty		Export	Settings		Page 1/2	Historical Price Table	
Generic 1st 'CL' Future							
Range	06/30/2021	-	09/08/2021	Period	Daily	High	75.25 on 07/13/21
Market	Last Price		Volume	Currency	USD	Low	62.32 on 08/20/21
View	Price Table					Average	69.99 373,788
						Net Chg	-4.35 -5.92%

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