

## BKI Quarterly Report



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- ♦ The drivers behind the fall in oil.
- ♦ Impacts of lower oil on equity markets.
- ♦ Does a low oil price provide investment opportunities?

### ***“Oils Ain’t Oils”*** *Caltex GTX advertisement slogan ~1988*

Welcome to the 10th issue of the BKI Quarterly Report. This report and previous issues are available on our website at [www.bkilimited.com.au](http://www.bkilimited.com.au).

In this edition we take a look at what has been dominating global headlines for the last 3 years... oil. As you will remember Brent Crude Oil was trading in a constant range of US\$90-US\$110 per barrel (bbl) for the best part of five years, until December 2014, when the world was “shocked” to see it fall to US\$60/bbl. By August 2015 the price had collapsed further and traded down past US\$50/bbl. In January 2016 the world really took note. Brent Crude Oil seemed to be in free fall, trading lower and lower until it hit US\$29.38/bbl on the 20th January 2016; and with this the world, its economies and its stock markets really did begin to panic.

It is important to remember that oil is a commodity, it behaves like a commodity and its price moves higher or lower like a commodity. These price movements are a direct correlation to basic supply and demand. The continual and significant decline in oil price from ~US\$110/bbl to ~US\$50/bbl was a result of large fundamental imbalances in world oil production, which grew by 2.4 million barrels per day (mb/d) in 2014. To make matters worse demand growth was only 1.1mb/d. This continued through 2015 and into 2016. We are not in the game of forecasting or predicting what the price of oil is going to be one, three or ten years from now. However according to a report from the US Energy Information Administration, global oil inventories are forecast to increase even further by an annual average of 1.6mb/d in 2016 and by an additional 0.6mb/d in 2017. So it may be a volatile time for the oil price for a little while yet.

While we see lower oil prices as a great opportunity for parts of the economy and for many individual stocks within our market, we think it appropriate to step back and ensure we are comfortable with the issues facing the countries most at risk and what (if any) consequences there may be if some of these countries fail to deal with receiving lower export revenues for a long period. So it's important to consider what has caused the oversupply and lack of demand. It will also help set the scene on how we are trying to take advantage of the situation:

- Oversupply can be attributed to 1) A rapid growth in US shale gas production, worldwide LNG, thermal coal and renewable energy, 2) A significant increase in capacity and storage of both oil and gas, and 3) The failure of oil cartel OPEC (Organisation of the Petroleum Exporting Countries) to agree to new production limits.
- Lower demand growth for oil has been caused by slowing economies around the world who continue to struggle with lower interest rates, higher unemployment levels and a basic lack of long term investment and spend from both public and private sectors.

Higher cost producers, involved in oil sands, offshore (mainly Arctic reserves), bio-diesel, ethanol and shale have been hit the hardest. Shale in particular is a relatively new concept and we see many producers with stretched balance sheets and wells that are both sub-scale and inefficient. Many North American businesses are under significant pressure due to the lower oil price. In a cruel way many of these businesses going into receivership is positive for the broader market as it takes out a level of supply. The knock on effect though is more concerning, with private, institutional and corporate funding all now exposed to bad debts which can slow economies even further.

The major concerns stem from the very low oil price against much higher costs of production. There are two considerations for costs - 1. Getting it out of the ground or sea and 2. The nation costs where hydrocarbons is the major source of budgetary revenue - Saudi Arabia, Norway, Russia and the United Arab Emirates being some of the most important. Here it can be argued that after concessions to the populace, the costs are more in the range US\$60 to US\$90 a barrel against less than US\$30 a barrel in getting it out of the earth or sea. In some cases where the nation has a large sovereign fund - or the equivalent in forex reserves - for instance Saudi Arabia, Russia, and Norway - assets including equities can be sold down to meet the pain in the short term. While these funds are enormous so too is the revenue gap left by the low oil price. If some of these governments stop supporting their populace, recession and civil unrest can be the result.

Countries like Venezuela are already affected. However it's the effect on citi-states and countries that were built on the back of the significant revenues generated from exporting oil such as Dubai, Abu Dhabi, Russia, Saudi Arabia and Norway that will impact global economies in a more meaningful way.

### Don't throw the baby out with the bathwater!

A common phrase used in equity markets; German proverb, "das Kind mit dem Bade ausschütten", which was first written by author Thomas Murner in 1512, sums up this global panic brilliantly. An extract from Wikipedia shows the illustration depicting Murner's phrase of a woman tossing a baby out with waste water. Some claim that the phrase originates from a time when the whole household shared the same bath water, the last to bathe was usually the baby. The water would be so black from dirt that a baby could be accidentally "tossed out with the bathwater"... like a good stock in a falling market.

So what got the entire global market in a spin was 1) The downturn in oil dependent countries, citi-states and regions; 2) The levels of significant capital outflows and asset sales from Sovereign Wealth Funds needed to continue to fund these economies; and 3) The high cost of production - leading to many companies deferring or cancelling a number of projects, lowering rig counts, announcing redundancies, dealing with unpaid debt and going into receivership.

For the year to February 29, 2016, investors in stock markets around the world left in droves. The Dow fell by 6.5%, the NASDAQ fell by 7.0%, the FTSE fell by 8.5%, the NIKKEI fell by 13.2% and here at home the S&P/ASX300 Accumulation index fell by 13.4%. Investors seemed to sell first and then asked questions later. For us, what much of the markets seem to have over-looked is that a lower oil price eventually leads to an economic boost in lower fuel pricing, and the opportunity from pressure caused by these large Sovereign Wealth Funds.



There are many companies and industries where the cost of fuel is a key input in their business model - we will address this shortly and why it is a benefit to BKI holding a diversified portfolio of stocks.

The phrase, "Don't throw the baby out with the bathwater", in investing terms simply means that in panic mode, many investors get caught selling their whole portfolio good stocks and all in a sell down. At BKI we remain disciplined in these bearish markets and are never tempted to sell all our stocks, but instead look extra hard to find investments that are not affected by all the noise and buy them at a cheaper price. Long term investing is always about trying to take advantage of mispriced valuations. Does a lower oil price mean that all countries are at risk, or all economies are at risk or that even all stock markets and stocks are at risk? Never throw the baby out with the bathwater!

## Does diversification work?

The short answer, we believe, is yes; although a diversified portfolio can work in many ways. Some investments themselves have a diversified earnings base, while others are simply counter cyclical. For us it's satisfying to see diversification in action when the market is on the ropes and certain stocks that we have added to the portfolio over many years prosper in adverse circumstances.

Some of the industries that we believe will be beneficiaries of a lower oil price include; Transportation, Manufacturing, Agriculture, Retail/Consumer and Utilities. Companies involved within the Mining sector will be able to use lower diesel prices to help offset the decline in commodity prices. At the corporate end, a fire sale of assets out of a Sovereign Wealth Funds could also be an opportunity for certain investors. In these cases, where raising cash is a priority, it's most often than not the better quality assets that are sold first.

## Are there any advantages in lower oil prices?

### Economy

Key arguments revolve around the significant impact on energy demand caused by changing demographics: ageing populations and urbanisation in particular. Based on the UN World Population Prospects, world population will increase from 7.2 billion in 2014 to 9 billion in 2040. Population growth in the OECD region is expected to be modest. Most population growth is likely to come from developing countries. The Middle East & Africa is expected to exhibit the highest population growth rates in the next 25 years, while China's population according to modelling done in this report would peak in 2028, and India would surpass China as the country with the largest population around 2026.

In the current market the supply of oil is there but demand growth is slowing. This is also true of both coal and gas. However over time we believe this dynamic will change. As can be seen below, forecasts by OPEC in "World Oil Outlook 2015" suggest that while nuclear, hydro, biomass and other renewables continue to grow, the growth in coal, oil and gas is just as significant. Despite the increase in nuclear, hydro, biomass and other renewables, coal, oil and gas between them are forecast to still account for over 77% of global fuel usage by 2040. Gas usage is expected to grow by 88%, coal by 29% and oil demand is expected to rise by 19% to 100.6 million barrels of oil equivalent per day (mboe/d).

Most fuel importing nations should be direct beneficiaries of a lower oil price. Economies in India, Japan, UK, Germany, Singapore, France, Italy, Australia and the world's largest oil importing country China should all be better placed in the short to medium term if oil prices remain low. According to a research note by Bank of America Merrill Lynch, China's GDP is estimated to increase by approximately 0.15% for every 10% fall in oil price; this suggests a growth in GDP of 0.6% as oil falls from US\$50/bbl to US\$30/bbl. A report from the International Monetary Fund is even more bullish, suggesting that a weaker oil price could boost China's GDP in 2016 by up to 0.9%. As most of China's exports are manufactured goods (and these prices have not appeared to fall in the current environment) the margins on goods produced should increase. The flow through of this into the Chinese economy through higher wages or higher corporate profits would lift local wealth, investment and living standards.

	Levels <i>mboe/d</i>				Growth <i>% p.a.</i>	Fuel shares <i>%</i>			
	2013	2020	2030	2040		2013	2020	2030	2040
Oil	84.4	90.1	96.1	100.6	0.7	31.5	30.2	27.9	25.2
Coal	76.1	84.2	92.4	98.3	1.0	28.4	28.3	26.8	24.6
Gas	59.2	69.1	87.7	111.5	2.4	22.1	23.2	25.5	27.9
Nuclear	13.1	13.9	17.5	23.5	2.2	4.9	4.7	5.1	5.9
Hydro	6.3	7.4	8.9	10.2	1.8	2.4	2.5	2.6	2.5
Biomass	26.2	29.1	33.6	38.1	1.4	9.8	9.8	9.8	9.5
Other renewables	2.4	4.3	8.4	17.4	7.6	0.9	1.4	2.4	4.3
<b>Total</b>	<b>267.6</b>	<b>298.0</b>	<b>344.6</b>	<b>399.4</b>	<b>1.5</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>





## Industry

As we have said, a lower oil price should lead to a lower fuel price. This then shifts the benefit from the companies who are oil producers to those companies who are oil users, including those involved within Transportation, Manufacturing and Agriculture. Mining, while also having to contend with lower commodity prices, will be better off given the lower overall cost base. Lower fuel costs can lead to larger company profits, better margins, further employment, investment and higher dividends to shareholders. It is these companies providing growth in situations like this that again highlight the benefit of holding a diverse portfolio of stocks.

In terms of oil demand, road transportation is the most important sector with 38mboe/d of demand in 2014 (or 44% of total demand). According to The OPEC 2015 World Oil Outlook Report, oil as a percentage of total demand is expected to fall to 42%, however total oil consumption is expected to grow significantly to 44.4mboe/d in 2040.

In the same report, OPEC forecasts that other industries such as steel, glass and cement production as well as construction and mining industries could require as much as 14.6mboe/d by 2040, which is up from 13.1mboe/d in 2014, while demand in the aviation sector is expected to total 8.4mboe/d by 2040 (6% of total oil demand).

We've asked the question on what a lower oil price actually means and if all countries, economies or stock markets are at risk. To ensure we haven't thrown the baby out with the bathwater we have done a significant amount of work on each stock in the BKI portfolio on this topic. We believe that BKI has a few key holdings within the portfolio that should benefit from a weak oil price and produce earnings and dividend growth in a period dominated by investor negativity.

**Transurban Group (TCL)** – TCL manages and operates 14 toll roads in four key markets across Australia and the US. Combined these roads total 1,192 lane kilometres and host over 5 million customers. TCL states that "Our roads are designed to reduce congestion and travel times compared with alternative routes, resulting in improved vehicle fuel efficiency and reduced emissions". The more economic it is to drive a vehicle - the more people will use toll roads. Sounds simple but that's the reality of it. Lower fuel prices further encourages drivers to use toll roads and with over 5 million customers TCL should benefit significantly from this low oil price scenario.

**Lindsay Australia (LAU)** – As stated in the 2015 LAU Annual Report, their fleet travelled a record of 57.2 million kms during the year. One of the single largest costs "Fuel and Oil costs" totalled \$39.7m. LAU's trucking fleet consume millions of litres of diesel per annum, so any reduction in diesel price reduces the total cost of road transportation for customers. Lower transport costs make the Australian road freight industry more attractive to customers, which over time should lead to companies like LAU attracting more clients that will ultimately lift utilisation and increase earnings and returns to shareholders.

**QUBE Holdings (QUB)** – The QUBE Logistics division has strategically located facilities in ports of all Australian capital cities. QUB provides road and rail container transport, in fact they have extensively developed and expanded their logistics portfolio to become Australia's single biggest provider of logistics services. In FY2015 QUB spent \$106 million on "Fuel, oil and electricity costs".

**New Hope Corporation (NHC)** – The 2015 OPEC Annual Report stated that for the developing world, coal will remain the leading source of energy, making up 30% of total energy consumption by 2040. This is due to its low cost, widespread availability and reliability as an energy source. In 2015 NHC's "Cost of Sales and Marketing/Transportation" expenses were 82% of Total Revenues. Diesel is one of the largest costs in running a mine – Excavators, Dozers, Trucks, Graders etc. With lower diesel prices the cost of production should reduce and enable NHC to become even more competitive.

**Sydney Airports (SYD)** – SYD is Australia's international gateway and primary airport. It injects a substantial amount of funds into the local and national economy each year which according to the company is "estimated at \$5.5bn directly and \$20.8bn when flow-on effects are considered", equivalent to 6.4% of the NSW economy. Aviation (according to the OPEC 2015 World Oil Outlook Report) accounts for 6% of global oil demand. Lower prices in oil can lead to lower operating costs by carriers which leads to lower ticket prices and larger volumes of aircraft and higher passenger numbers.

## Consumer

The shift in profits away from oil producers to industry and consumer is wide ranging. The consumer benefits at this point are twofold. Companies involved in Transportation, Manufacturing and Agriculture can distribute greater earnings or lower prices into an economy through employment, investment and dividends, which eventually finds its way to the consumer. However the consumer (in this case it's all of us with a vehicle) has another free kick too, cheaper fuel!

**ARB Corporation (ARB)** - ARB is Australia's largest manufacturer and distributor of 4X4 accessories and their export network extends through more than 100 countries. In fiscal 2015 ARB once again delivered sales growth. While the company stated that demand from customers associated with the mining industry is weak, sales growth in the Australian aftermarket is strong, in many ways driven by 4X4 enthusiasts. Which confirms to us that lower fuel prices converts to higher 4X4 accessory sales.

**Caltex Limited (CTX)** – CTX is Australia's leading transport fuel supplier and convenience retailer and the only integrated oil refining and marketing company listed on the ASX. CTX is one of the largest retail platforms in Australia with over 800 sites. CTX have told the market numerous times that they have over 3 million customer visits each week. However, CTX is not the only company benefitting from retail fuel sales and we therefore go into more depth on the fuel industry below.

**Caltex Limited (CTX), Woolworths Petrol (Woolworths Limited) and Coles Express (Wesfarmers Limited).** Together this group accounts for a large portion of fuel sold within Australia. According to the January publication of Australian Petroleum Statistics (Issue 234), Total Sales of petroleum in Australia for the 2015 year was 55,159 million litres (ML) compared to 52,409ML in 2011, an increase of 5%. It is also interesting that diesel volumes rose 18% at the expense of unleaded petrol, falling 8%. This trend is consistent with CTX commentary over the last three financial years.

On a constant currency basis as at December 2015, the report suggests that Australia has the 4th cheapest unleaded petrol price per litre in OECD countries, behind the US, Mexico and Canada at \$1.25/litre. While in diesel, Australia ranks as the 5th cheapest behind the US, New Zealand, Canada and Mexico at \$1.26/litre.

Using these numbers from the Australian Petroleum Statistics report, let's assume that each of CTX's 3 million customers spend \$62.75 on 50 litres of fuel each visit at \$1.255/litre. Then assume that lower oil prices eventually convert into lower fuel prices, say down to \$1.00/litre. And that 50 litres consumed per customer per week at \$1.00/litre now costs \$50.00 per visit. This represents a saving of \$12.75 each week for 3 million CTX customers, an injection each week of \$38.3m or \$2.0bn each year back into the Australian economy.

Fuel retailing is a low-margin, high-volume industry. Taxes make up 40.5% of the price per litre of diesel in Australia compared to 13.4% in New Zealand, 13.8% in Mexico and 21.4% in the US. Tax on diesel in the UK is as high as 68% per litre. If we use CTX's customer base as another example, taxes paid on petrol at \$1.25/litre by the 3 million customers are estimated at \$3.9bn per annum, not a bad a contribution to the Government's taxation revenue.

## Looking Ahead

Since the lows in January, Brent Crude Oil is now trading 42% higher at over US\$41/bbl. While this is an improvement, it's by no means high enough to offset the cost of production in many countries. While the imbalance between supply and demand could take much longer to adjust than some commentators are suggesting, industry capex and rig count has already fallen dramatically. This should help to slow supply, which should see oil prices go up eventually.

As we continue to deal with volatile oil prices and the knock on effect this may have on equity markets we'll remain focused on managing shareholders capital sensibly, always aiming to pick up opportunities, regardless of the market environment or what everyone else is thinking or doing. We won't panic if Sovereign Wealth Funds continue to divest large parcels of their investments, we don't need to, we rather buy stocks on more attractive valuations where good stocks are simply just mispriced. BKI is a Listed Investment Company, a closed end vehicle. We're not beholden to outflows of capital as open ended fund managers are. We have a fixed share structure that allows us to take a long-term view and even in this environment, full of uncertainty and worry we're finding some great opportunities.

Tom Millner (March 2016)



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References: Lindsay Australia Limited “Annual Report 2015”; Caltex Australia Limited “Annual Report 2015”; ARB Corporation Limited “2015 Annual Report”; Sydney Airports Limited “2015 Annual Report”; Transurban Group Limited “2015 Annual report”; QUBE Holdings Limited 2015 “Full Year Accounts”; New Hope Corporation Limited “2015 Annual Report and Financial Statements”; US Energy Information Administration, “Annual Energy Outlook 2015 with projections to 2040”; United Nations “World Population Prospects The 2015 Revision Key Findings and Advance Tables”; BofA Merrill Lynch Global Research 2016 outlook “2016 Year Ahead Outlook”; International Monetary Fund “World Economic Outlook January 2016”; OPEC “2015 World Oil Outlook” Report; Australian Government, Department of Industry, Innovation and Science, Office of the Chief Economist, “Australian Petroleum Statistics”, issue 234, January 2016.

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