INVESTOR'S REPORT

THE BEST PROFIT STRATEGY FOR ANY OIL PRICE ENVIRONMENT

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The Best Profit Strategy for Any Oil Price Environment

The recent crude oil pricing trend has been long and decidedly negative. WTI crude prices fell a stunning 55% year over year by August 2015.

WTI Oil's Yearlong Crash
Prices for the U.S. benchmark have cratered 56.4% in the last year. Here's how futures have trended since August 2014:

Sources: Marketwatch, Money Morning *Staff Research*

But this cycle is near the bottom.

You see, there are two reasons why oil is about to reverse its price slump. Investors who act now will get ahead of the looming price rise.

Even better for investors – it is no longer necessary that crude prices accelerate for selected and well-located companies to spike in value. Successful oil investing is all about positioning in the upstream-midstream-downstream process.

That means you can start making money in the current low-price environment now. You just need an exacting approach and an exhaustive understanding of the variables on which to focus – which we outline here.

First, let's look at the forces ready to drive oil higher...

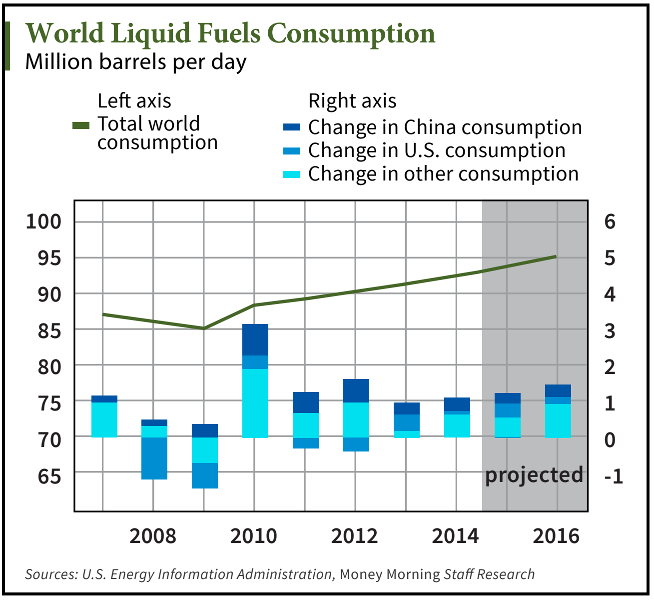
Two Factors to Boost the Oil Price Curve

The first development ready to push oil higher is trading activity.

Oil shorts now account for an exceptionally high ratio against long positions – the highest ratio we've seen in the past five years. The U.S. Commodity Futures Trading Commission (CFTC) reported 9.5% open short interest in light sweet crude futures and options on the New York Mercantile exchange as of Aug. 11. That's up nearly 21,000 short positions from the week prior.

This means any upside improvement in price will be compounded by a massive covering of those short positions and a proportionate increase in oil prices.

The second factor ready to move oil prices is demand.



Subdued market prices, surplus production, and concerns over a Chinese economic slowdown are all listed as the reasons for supply-side concerns. But demand is not declining.

In fact, and despite some volatility in numbers, both the OPEC Secretariat in Vienna and the International Energy Agency (IEA) in Paris point toward record global daily demand by the end of this year.

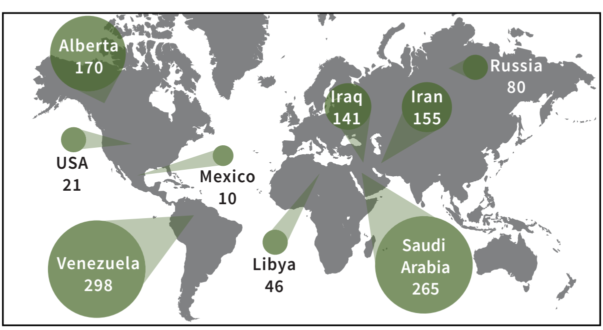
That means, regardless of what price per barrel is being set in New York and London, refineries (the primary end user of crude oil) will still need guaranteed volume flows. There will always be companies that survive the malaise and register profits.

To spot the best ones for investing, you can use these three strategies...

Use the Reserve Multiples "Yardstick"

The "yardstick" is a tool that helps examine the relationship between a company's booked oil reserves and its trading price. That's important for investors because there is often a direct correlation between how much product is available to an oil producer and its profit potential. The yardstick will help you easily identify undervalued stocks and those in the best position for near-term appreciation.

Comparative Oil Reserves (billions of barrels)



Sources: Oil & Gas Journal 2012, Money Morning *Staff Research*

Reserve multiples address the estimated value of oil and gas a company has accessible, but not yet extracted. It can often make more sense to refer to these as *extractable reserves* – those assets in the ground that are both technically and financially extractable. They are what an oil and gas company can extract immediately at a cost that is justified by the current market conditions.

An extractable reserve multiple merely divides the total market value of oil and gas most easily extractable – though still in the ground – by the total market cap of the producing company. This should offer a relatively simple way to identify undervalued companies and the more efficient and cost-effective projects. These projects are the primary profit drivers and tend to benefit the overall valuation of a company's shares.

Reserve figures are among the most manipulated statistics in the business. But looking at *extractable* reserves in a way that considers both the effects of technology and economics accomplishes two objectives...

First, the extractable reserves figure, as opposed to broader reserve multiples, narrows down the overall reserve figure – beyond even what is required by the U.S. Securities and Exchange Commission (SEC). There are several classifications of reserves, categorized essentially by how probable it is that the reserves can be exploited. Focusing on the most extractable classification reduces the actual reserves you're considering to those with the highest probability of production.

Second, this approach places a clear and statistically verifiable distinction between reserves and resources.

"Resources" often include assets where extraction is not necessarily feasible – a prime source of the aforementioned manipulated numbers. Companies will often blur the distinction between these "resources" and actual, extractable reserves, especially where figures are calculated for foreign holdings.

Put simply, "resources" are less reliable and undergo less rigorous analysis than is applied to reserve categories – so focus on the reserves that are most likely to fulfill supply.

No matter what the market conditions, some companies are always rising faster than others. Smaller, well-managed, and narrow-focused producers perform better when using the reserve multiples as a yardstick. They will provide better profits per unit produced and higher stock appreciation than the big boys.

Mammoth companies, such as **Exxon Mobil Corp.** (NYSE: XOM), **BP Plc.** (NYSE: BP), **Chevron Corp.** (NYSE: CVX), and the like, may make a lot of money. But they do not end up with the best figures using those multiples.

Of course, this yardstick shouldn't be your only consideration when selecting investment plays. Aggregate supply and demand considerations, the broader corporate debt and working capital ratios, access to midstream and downstream transport and processing assets and at what cost, along with the market price itself, are certainly other important considerations.

But it is becoming a much more important measurement, and it is another way to find undervalued oil and gas stocks to buy that are likely to advance long before everyone else catches on.

Identify "Traditional" Producers

The cost of production is the most important financial metric for oil companies during lower price periods. Firms that pursue expensive onshore projects involving unconventional, horizontally drilled wells can lose tons of money when prices aren't near $100 a barrel. That's because higher production volumes don't offset higher operating costs when prices are near $40 a barrel.

The companies that prosper during lower price periods drill traditional, conventional, shallow, and vertical wells. These wells are quick in and quick out. They cost comparatively very little to complete, usually less than 10% of a deep fracked horizontal. Dry holes, therefore, are less of a problem in a drilling program that can finish wells in a week, as opposed to several months.

So when oil prices drop, extraction from shallow vertical wells tends to crowd out production from more expensive competitors.

Why? It's due to one simple overriding factor. Traditional wells are often profitable at $65 a barrel, and sometimes even less.

Remember, supply may be up right now (resulting in lower market prices), but demand – even a sluggish demand scenario – will still require product.

So the "cheaper wells" end up grabbing a greater percentage of an existing market, and the companies that drill those wells actually *benefit* from the falling overall price. They just grab a bigger market share.

In short, these projects are designed to move right into today's oil "sweet spot" where the bulk of the profits will be made. And, of course, those profits continue for the life of the wells. That could easily be 10 or 15 years or even longer – in all pricing environments.

That's the advantage of owning what comes out of the ground, not simply stock issued by a company looking for it.

Target M&A Activity

The past year's oil price crash has seen many companies go belly up. One such firm is Hercules Offshore Inc. (Nasdaq: HERO), the Houston-based drilling company that filed for Chapter 11 bankruptcy on Aug. 13. The low-price environment has primed the oil sector for a wave of M&A activity, resulting in a new group of heavyweight companies that will lead the market into a "new energy age."

The cost of new debt – if companies can even acquire it – is becoming prohibitive. Debt costs are the fastest rising reason for a new cycle of M&A. Aside from the state producers in the leaders of OPEC (Saudi Arabia, Kuwait, and the United Arab Emirates), few companies anywhere on Earth can finance the next round of projects with petty cash.

But given that global demand is still rising and production will be needed, where is the money going to be sourced?

The new financing arrangements taking shape are a twist on what was once the main way solvent international companies financed most of their future projects. Until recently, credit lines were the main financing instrument. But that would not always mean floating junk bonds at unsavory double-digit interest, as most companies face these days.

Rather, the process usually went something like this... An experienced company with a track record of successful projects would secure a line from a lead bank. The bank would then syndicate that credit with other banks to lower the individual institution's exposure to risk.

Banks and producers would iron out an agreement with both sides discounting the transaction.

The company would deliberately underestimate the proved reserves they had available in the ground while the bank would deliberately underestimate what the market would pay for it. The resulting credit line would be used to fund the project.

In a more or less stable environment, the discounted volume on one side combined with the discounted market value on the other would guarantee a profit margin for both the company and the bank(s).

This came to an end once the world entered into the credit crunch of 2009-2011. With banks no longer lending to each other, the syndication approach could not work. If a lead bank chose to fund a project anyway, it would be carrying the risk alone. That risk quickly translated into interest rates simply too high for any company to accept.

Today, however, this process is returning, albeit it with an important difference. Syndications are now becoming an alternative way for companies to value productive assets and secure credit based on them. This is as likely these days to be funding for general operating expenses as it is for a specific future project.

But it nonetheless allows us to do something quite important when it comes to identifying oil and gas companies in which to invest. It comes down to this...

Those companies with assets that can be collateralized (not subject to sale) will be able to access funding at more affordable rates by using the syndication approach. Therefore, those able to withstand the volatility of the market and its price swings will be those that can avoid floating junk bonds. These are the survivors and targets for M&A, resulting in profit for stockholders.

In short, knowing who can use production, fields, and leases as collateral will translate into a list of operators that are going to provide returns to average retail investors...

The Bottom Line: Lower crude oil prices and price volatility have the effect of chasing investors out of the oil and energy sector altogether. But the world will keep needing oil. Knowing how to spot the healthiest oil producers will keep you profiting through any pricing environment.

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