AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive **22nd January 2016**

A Liquid Stimulus Package

Over the past few weeks there have been no shortage of headlines detailing the woes of the large oil companies as the oil price has continued to fall. Indeed this week, the oil price came under further pressure (hitting 12 year lows), as the prospect of lifting sanctions on Iran raised the spectre of an additional 500,000 barrels of Iranian oil daily hitting the global market. Whilst this has placed a significant amount of stress on oil producers and in particular companies such as Santos and Origin Energy that are completing export LNG projects that require a high oil price to generate commercial returns; the dramatic and sustained fall does have some positive impacts for investors and the economy.

In the first weekly piece of 2016 for *The Alternative View* we are going to look at the beneficiaries of the sustained decline in hydrocarbon prices. Conceptually a fall in the price of oil is not deflationary or negative *per se,* but rather a transfer of wealth from oil producing countries and companies (such as OPEC, Norway, Exxon and Oil Search) to energy consumers (OECD, South Korea, China, chemical companies and domestic consumers).

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Over the past two years (despite a 20% fall in the AUD), Australian consumers have seen a 60c decline in the petrol price at the bowser, though in researching this piece I was surprised to see a great dispersion in prices for a litre of unleaded in Sydney from $1.49 in Edgecliff to $0.99 per litre in Marrickville[1].

Australian consumers

Australian Bureau of Statistics (ABS) survey reveals that households spend an average of $60 each week on fuel for vehicles, and $41 on gas and electricity for their homes. This equates to average energy expenditure representing 5.3% of total gross weekly household income (2.0% for dwelling energy and 3.2% for fuel for vehicles). The sustained

[1] See PetrolSpy 20/1/2016 http://petrolspy.com.au/#!/station/536357fd0364bc591f2b7725

fall in energy prices over the past year has resulted in an additional $1,154 per annum being added to the average household's finances, with a greater benefit being felt by those living on the periphery of the country's major cities. This additional cash improves the balance sheet of the nation's consumers that can either be spent on consumption or on paying down debt.

To put this in perspective Kevin Rudd's $10.4 billion "GFC economic security package" from October 2008 delivered a one-off $1,400 to pensioners and $1,000 per child to families and was credited as boosting GDP by 1%. Arguably the benefit received from falling petrol prices over the past two years should have a more sustained impact than a well telegraphed one-off payment.

Increased domestic spending

The largest beneficiaries of the stimulus package derived from falling petrol prices will be the consumer staples and consumer discretionary retailers. Savings on energy are spent on food and liquor, as well as consumer goods such as televisions and apparel. As such, we would expect to see stronger sales figures from ***Wesfarmers, Harvey Norman*** and ***JB-Hifi***. The falling AUD is likely to boost the proportion of this additional retail spend that is directed to domestic retailers rather than foreign online sales. ***Flight Centre*** is likely to benefit from both higher consumer spending and falling airline ticket prices (once fuel surcharges are removed).

Higher retail sales will also benefit retail listed property trusts such as ***Vicinity*** *and* ***Scentre.*** Typically a tenant in a shopping centre will pay a base rent, variable outgoings to recover the costs of running the centre and turnover rent based on a percentage of the retailers gross sales. This provides an automatic mechanism for rent to rise when there is an uptick in retail sales. We have seen this in the building momentum in retail sales throughout 2015, particularly in footwear, leisure, jewellery and technology sales as reported by the retail listed property trusts. However I concede that a portion of this improvement in retail sales is also due to a falling AUD, which has resulted in less online spend and an increase in domestic inbound tourism.

Large energy consumers

Amongst the companies that consume large amounts of hydrocarbons, ***Qantas*** is the most obvious beneficiary. The company has seen their jet fuel bill decline from $4.5 billion in 2015 to A$3.9 billion in 2015, with A$3.5 billion expected in 2016. In 2015 this caused a dramatic one year turnaround in profitability from a loss of -A$646 million in 2014 to a profit of A$975 million, aided by higher domestic volumes and the slow removal of the fuel surcharges, which added as much as $570 to an economy class ticket from Sydney to Los Angeles!

Miners such as ***Rio Tinto*** and ***BHP*** are significant consumers of hydrocarbons. Moving dirt consumes a large amount of energy in both cracking the rocks and removing overburden through explosives to moving iron ore and coal to the ports on the coasts off Western Australia and Queensland. Rio Tinto's iron ore division alone spent over A$500M on fuel in 2014 and falling energy prices and a weaker currency will help offset the fall in mineral prices. ***BHP*** by virtue of its US onshore oil and gas acquisitions is a net energy producer and has written down these assets thrice since 2012.

The petrochemical companies should see a benefit from falling energy prices. ***Orica*** and ***Incitec Pivot*** are major consumers of natural gas and ammonia, which they use to manufacture explosives and fertilizers both in Australia and globally. Incitec Pivot is seeking to capitalise on US shale gas by constructing a US$850 million ammonia plant in Louisiana which is expected to be completed this year.

Oil importing nations

Whilst falling energy prices have been causing much angst in the oil exporting nations, these declines should provide a boost to the major oil importing economies of China, Europe and Japan. Improving sentiment in the US and Asia will have a bigger impact on the prospects for global growth and Australian exports than oil-induced recessions in Russia, Saudi Arabia, Venezuela or Iran.

The nation that is likely to see the biggest benefit from falling oil prices is China, which in 2015 surpassed the USA as the largest net importer of crude oil and other liquids in the world (7.4 million barrels of oil per day). Clearly a factor that stimulates the economy of Australia's largest export partner (24% of Australia's trade in goods and services) will have a positive impact on a number of Australian listed companies from miners, tourism operators to foodstuff exporters.

Our Take

Whilst most of the attention in the financial media relating to falling oil prices, the companies that have a negative exposure to a falling oil price only comprise 3% of the ASX200 (or 6% including BHP) and employ a small proportion of the Australian workforce. Whilst the fall in oil prices makes for sensational headlines and has generated significant investment banking fees from two large capital raisings, we see that there has been minimal attention being placed on the positive impacts of the fall and that the sustained fall in the oil price is akin to an extended stimulus plan with greater and more lasting benefits than the hand-outs of 2008-09.

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