FAWKES CAPITAL MANAGEMENT

Beach Energy (BPT)

10 October 2021

In this article we outline our investment thesis behind our recent holding in Beach Energy. We believe Beach Energy represents a compelling investment opportunity at current prices for several reasons:

- Strong growth outlook with an excellent management team and healthy balance sheet
- Supportive macro backdrop over the shorter and longer-term
- Valuation upside with a healthy margin of safety

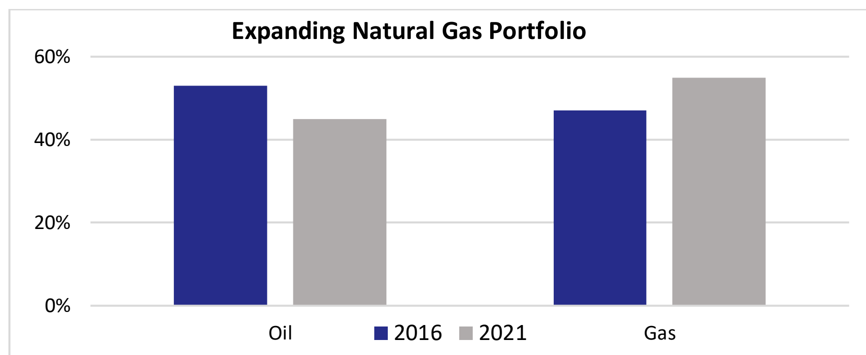
Further information relating to our investment views can be found below.

Disclaimer: This article represents the views of the author and does not constitute financial advice. Please seek professional advice before making any investment decisions. Fawkes Capital Management owns shares in BPT.

Background

Beach Energy is one of Australia's largest oil and gas producers. The company operates five oil and gas producing basins across Australia and New Zealand and is a major supplier to both the Australian East-coast market and New Zealand. The company has also been increasingly looking to enter global LNG markets for further growth opportunities with promising recent success.

While Beach's assets include ownership interests in both strategic oil and gas, this has been transitioning further in favour of gas production over recent years.



Beach has been an extremely well-run company. Management has maintained a conservative balance sheet, (especially compared to many of its peers who are burdened by heavy debt) with a net cash position. It has a strong track record of sensible capital allocation, evidenced by its highly profitable natural gas business. As a result, it's emerged in a strong financial position relative to many peers after a period where COVID-19 decimated commodity prices.

Growth Outlook:

Our outlook for Beach is supported by a promising growth story we believe the market has failed to price in.

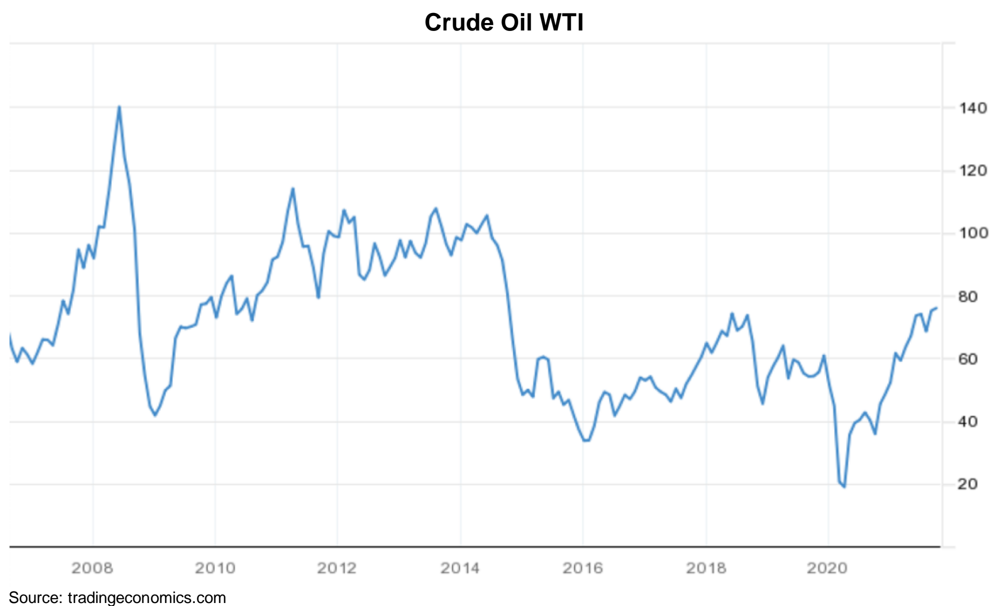
- Approximately 40% of the company's revenue is based on fixed-price, CPI-linked gas supply and has helped the company deliver within its FY21 underlying EBITDA forecast of $900 – 1,000m. These stable gas earnings are expected to be further supported in coming years following two favourable re-pricing events on the company's Lattice Cooper Basin and Otway Basin gas contracts, as well as increased growth in production.
- While we don't ascribe any value to them currently because of our margin of safety / conservative approach, Beach also owns a significant number of promising exploration and production tenements surrounding their current production assets. These tenements include onshore Cooper and Perth basins, onshore and offshore Otway Basin as well as offshore acreage in the Bonaparte (Australia) and Taranaki (NZ) basins, offering potentially significant further growth optionality. The company has been well managed, with sensible capital allocation and a conservatively geared balance sheet, especially for a commodity producer, and as such, is well placed to pursue these additional growth opportunities in the future.
- Beach is also in the process of increasing its global presence, having recently announced that it will supply all of its share of the LNG generated from the Waitsia Stage 2 project to BP Singapore. The agreed pricing

under the Heads of Agreement is linked to Brent and Japan Korea Marker prices. This will provide a further uplift in gas production and future group revenues as it comes online.

While Beach is currently pursuing several growth projects as outlined above, there are also strong growth opportunities within its committed projects. The company retains significant reserves, with asset lives ranging from 12-20 years, and is looking to grow current production at a CAGR of 13% for the next 3 years. With these new projects identified, as well as growth in production of existing projects, the company is well placed to increase cash flows materially above current rates. With the share price still close to two-year lows on the back of cyclical lows in commodity prices over 2020/2021, we'd expect to see a correction as results begin to materialise.

Macro Backdrop – The Future of Oil and Gas Prices

Global oil and gas prices have risen materially from their cyclical lows in 2020.



Source: tradingeconomics.com

Near-Term Outlook:

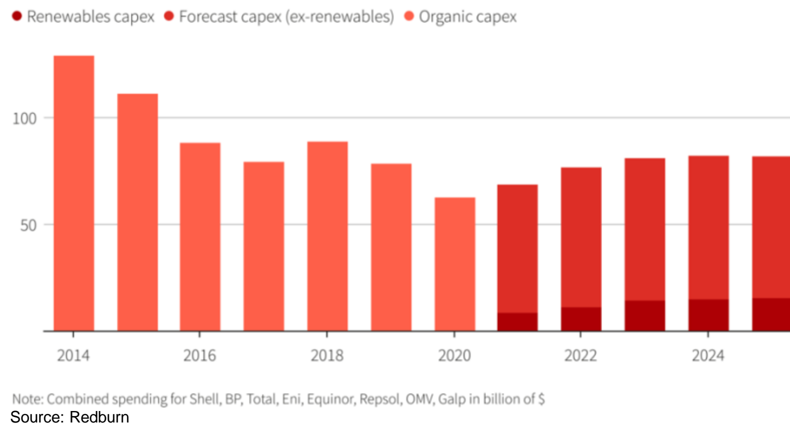
In light of the current environment, we continue to expect prices to remain elevated:

- There's a risk of a gas crisis coming into the Northern European winter. Gas storage sites across the European Union and the UK sit at just 76% of capacity, compared to the historical ten-year seasonal average of around 90%. If this winter is to see a drawdown in line with historical gas drawdowns, storage sites would likely be reduced to their lowest levels in decades, leaving the region with persistent shortages next year. A larger than average gas drawdown would increase the probability that gas would run out in some areas.[1]
- The cost to ship/import supplies has risen rapidly in light of global shipping disruptions (see charts below) and is expected to remain elevated heading into Christmas followed by the Chinese New Year. Historically, similar disruptions have taken six to twelve months to unwind.[2]

[1] https://www.reuters.com/business/energy/europes-gas-prices-surge-avert-risk-winter-shortage-kemp-2021-10-06/
[2] https://www.economist.com/finance-and-economics/a-perfect-storm-for-container-shipping/21804500

Source: The Economist

- Unlike previous cycles, there's been a general hesitancy from many oil and gas producers around the world to invest in capital expenditure to keep up with the recent rise in prices. This is due to a combination of many still in the process of rebuilding their balance sheets following severe COVID-related disruptions, as well as a focus on rolling out strategies more in line with a shift to renewables and lower carbon fuels. US shale companies, who were the marginal supply in the last oil cycle, have decided to preference shareholders and financial stability over capital expenditure following their near-death experience during the COVID crisis.



Source: Redburn

Longer-Term Outlook

The world is currently undergoing a great transition away from fossil fuels towards renewable energy. As the chart above shows, the amount of capital expenditure that is currently, and expected to be spent on oil in future years is low relative to historical levels as a result of this transition. Going forward, we don't expect spending to track oil prices as closely as it has done in the past. This dynamic should benefit current producers.

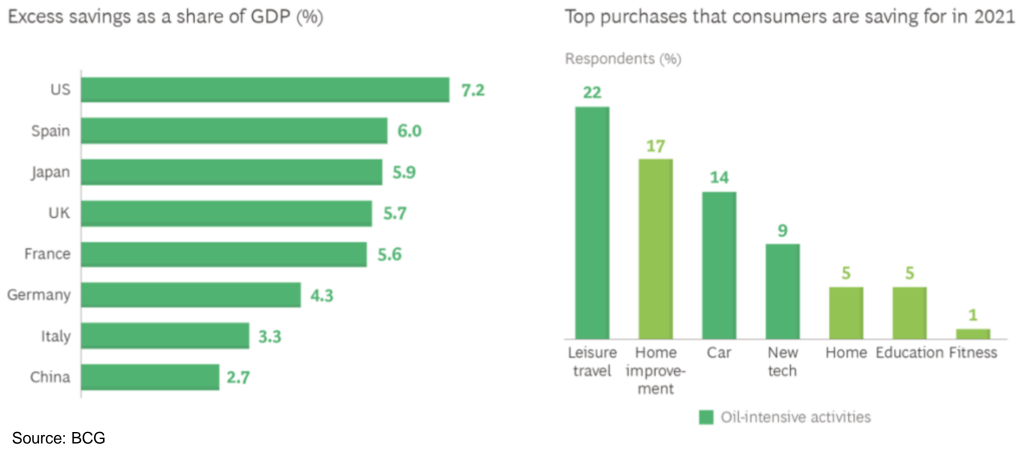
Based on our research into the solar industry, the pace of capacity expansion is slow relative to what would be required to power the world. Broadly speaking, Bill Gates estimates in his book (*How to Avoid a Climate Disaster*) that we would need annual solar and wind production to triple over the next few years. Comparatively, First Solar, one of the US's largest solar panel manufacturers is planning on increasing manufacturing capacity by around only 40% in the next few years. Wind farm production has also been hampered by the lack of ships required to transport custom parts to their required destination. Current supply plans simply aren't enough. At the same time, as the world population grows and gets richer, energy demand will only go up. Based on current policies, Bridgewater, an investment management organisation, estimates that oil demand growth will continue to increase until at least 2030.[3]

As Australia and the rest of the world continues to emerge from COVID, expected spending patterns, supported by high levels of household savings, suggest that demand for oil and gas will continue to exceed supply. We expect this to take some time to play out, with countries opening gradually as vaccination rates increase. It's expected that jet

[3] https://www.bridgewater.com/_document/what-will-the-global-push-to-net-zero-mean-for-oil?id=0000017b-6477-dcb2-a57b-f47f07e50001

fuel demand, a major fuel that remails materially lower than at pre-pandemic levels, is not expected to recover until at least 2024.[4]

With Significant Savings Accumulated, US Consumers are Primed to Spend



Source: BCG

Valuation

As highlighted above, oil and gas prices are up significantly since their dramatic falls in 2020. This period was perhaps one of the toughest market environments for producers. However, things have improved materially since then, with prices now back around their cyclical mid-point for oil and expected to remain higher going forward.

After accounting for operational expenditures on the company's existing assets, Beach Energy generated, on average, around $600m of free cash flow (FCF) per annum over the last two years. These years, however, were tough years due to oil prices at cyclical lows. The years prior to COVID, over 2018/2019, were more normal years, where oil and gas prices hovered around their historic midpoint. During these years, Beach Energy generated FCF of around A$900m p.a. At a market cap of around $3bn, the company currently trades at around 3-3.5x normalised FCF. With long asset lives and attractive growth opportunities, the opportunity to buy a commodity that will still be in use in 10-15 years at 3x normalised FCF is extremely appealing.

Should the company fundamentals or the macro-outlook evolve, we will look to revisit our conviction. However, given our views on the growth expectations for the company's current and future projects as well as a supportive macro environment, we believe the share price represents material upside with a significant margin of safety to protect from capital loss.

[4] https://www.bcg.com/en-es/publications/2021/preparation-for-last-oil-price-boom