INVESTING

YOUR MONEY AT WORK

PAIN AT THE PUMP WITH OIL ON THE MARCH, AMERICANS SHOULD PREPARE FOR GAS PRICES TO CLIMB TOO.

Time to Bet on Oil Again

The collapse in *the price of crude has caused companies to slash budgets*—setting *the stage for a rebound that should propel stocks higher.* BY MINA KIMES

EVER SINCE CRUDE hit a record high of $147 per barrel last July, owning oil stocks has been a little like bungee jumping—a long, terrifying plunge that you pray will be followed by a life-affirming bounce. Well, it may finally be time to exhale. With oil rebounding to more than $50 for the first time since November, there is a growing consensus among industry analysts and investors that the stage is set for a multiyear rally that will propel stocks higher. "The question is not if, but 'How fast? How much?'" says longtime Oppenheimer analyst Fadel Gheit.

Given the fact that the current economic downturn is both more severe than any in decades and global in its reach, it might seem counterintuitive to be bullish on oil prices. Indeed, worldwide demand will sink 1.6% this year, according to the Energy Information Administration. That means that our oil-thirsty society is in the rare position of having excess capacity on its hands—hardly a price-booster in the short run.

But while consumption is trending down, analysts are projecting that supply will fall even further in the years ahead. In a report called "The Long Aftershock," oil industry consultancy Cambridge Energy Research Associates (CERA) recently warned that production might reach only 101.4 million barrels a day by 2014—or some 7.6 million barrels less than it

Rally Time

Stocks surged in late March on hopes of an economic recovery, even though the profit picture remained bleak.

24.5%

Three-week gain in the S&P 500 as of April 3, the fourth rally of 12% or more since the market's record high of October 2007. Overall, however, the index is down 46% in that span.

37%

Average drop in profits for S&P 500 companies in the first quarter, according to analysts' estimates, in what would be a seventh straight quarterly decrease for the first time since at least the 1930s.

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projected last fall. "We're seeing the impact of the worst recession since the Great Depression on oil," says Daniel Yergin, co-founder of CERA. "A significant part of the supply that was anticipated to come onstream is now at serious risk." (For more from Yergin, see Q&A below.)

OIL STOCKS ARE ATTRACTIVELY VALUED RELATIVE TO THE BROADER MARKET.

The dropoff in future supply can be directly tied to last fall's plummeting prices. OPEC, desperate to keep oil above $50 per barrel, has been decreasing its output with a goal of cutting 4.2 million barrels a day from its members' daily production. Meanwhile, virtually every major independent oil company has been slashing exploration budgets and slamming the brakes on new projects. According to analyst Paul Cheng of Barclays Capital, the nine large integrated oil companies he covers have cut a total of $36 billion of planned capital expenditures over the past six months. All of which means that when demand does rebound, supplies will be hard pressed to keep up—creating the conditions for another surge. "The most important driver for oil stocks is oil prices, which bottomed in January," says Cheng. "We like the sector for the next few years."

There are other reasons to favor the oil sector right now. For one thing, it's attractively valued compared with the broader market. The Amex oil index currently trades at six times its earnings for the past 12 months and has a dividend yield of 4%, compared with the S&P 500's price/earnings ratio of 12 and 3.5% yield. Putting some money into oil producers also makes sense if you're worried about the impact of the government's efforts to revive the economy. Washington is spending trillions of dollars to bail out banks and stimulate spending. That could eventually drive down the value of the dollar—and boost inflation. Because oil is traded in dollars, a weaker U.S. currency puts particular pressure on the price of oil, as foreign sellers demand more greenbacks for their crude. So while you may be paying more for gasoline and heating oil may rise, at least your oil stocks will go up too.

One tried-and-true approach to betting on oil is to

Q&A

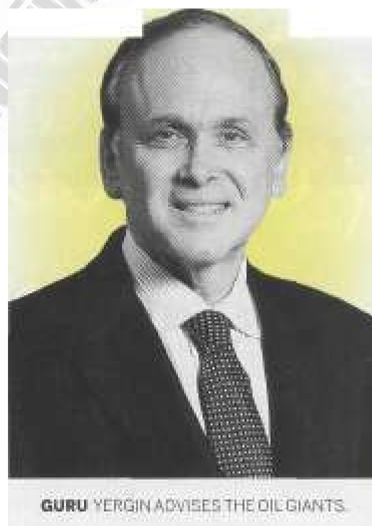
Daniel Yergin

Cambridge Energy Research Associates

ARE WE soon headed for $2oo-plus oil? Daniel Yergin, chairman of Cambridge Energy Research Associates, doesn't think so. But CERA recently warned that massive cutbacks in production, driven by the global slowdown, could severely cramp the growth of the world's oil supply—leading to a 7.6-million-barrel-a-day shortfall by 2014. Yergin, author of *The Prize,* a Pulitzer-winning history of oil, answers *Fortunes* questions about what's next for crude.

Why are you lowering your oil supply projections?
After this extraordinary collapse, everyone has had to go back and reprioritize. Projects further out have been postponed—items like deepwater exploration, wildcatting, and unconventional oil. These bigger, more expensive projects are being pulled back. That's how we could lose 7.6 million barrels a day.

Will consumption bounce back to what it was?
The U.S. reached peak demand, in terms of gasoline consumption, in 2007. Now we're looking at flat or declining demand into the future here. There's an increasing emphasis on energy efficiency, and climate change is becoming the driver of policy. But the world is divided between emerging and industrial countries. Since 1980, oil demand in the industrial world has gone up 20%, and in emerging markets it's gone up 40%. That's where the future is in terms of growth and oil demand.


GURU YERGIN ADVISES THE OIL GIANTS.

Are we headed back to $147 oil?
If at-risk investment doesn't happen and we get a strong surge in demand on the back of an economic recovery, then we could be back to a higher-price environment. But I think this time, when we start to see prices go up again there will be a greater sense of contingency. During the run-up, financial markets were deeply engaged in oil prices. There was an overpowering sense that this time was different, prices will go up forever, it won't affect demand. Now, in the energy markets, as everywhere else, there will be a greater emphasis on prudence.

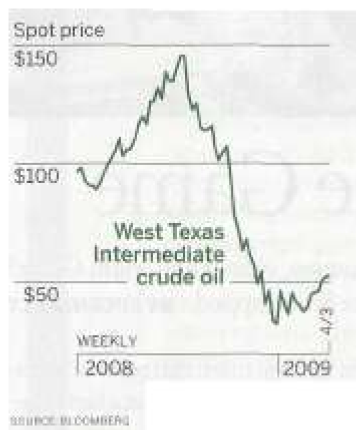
buy the biggest', most stable company in the sector. That, of course, is **ExxonMobil (XOM, $69)**, which, with $477 billion in revenues, is by far the largest of the supermajors and has the best return on equity. But many oil investors aren't wild about the stock at its current price. While Exxon is the largest holding in T. Rowe Price's $2.9 billion commodity-focused New Era Fund, manager Charles Ober says the stock, though ultrasafe, isn't worth its premium over its peers. Exxon has a P/E ratio of 8, the highest of the majors. Plus, Exxon's very size and stability mean that it probably won't rise as much as its smaller rivals if there's a strong move up in crude. "Right now, I'd rather have something that's more levered to the price of oil," says Ober.

Where should you look beyond Exxon? With future capacity in short supply, the best way to pick winners, analysts say, is to focus on the few companies that are positioned to sharply increase production. And among the oil giants, the company with the brightest outlook is **Chevron (CVX, $68).** Barclays estimates that Chevron will increase production by 2.7% annually through 2012, the best rate among the super majors. "Right now, Chevron has more resource opportunity than they've had in a long time," says J.P. Morgan analyst Michael LaMotte, who expects the company to work deals to get access to new reserves in countries like Iraq and Brazil. With a P/E of 6, Chevron is also cheaper than Exxon, and its dividend yield of 3.8% is nearly twice that of its bigger rival.

A pair of mid-majors also offer robust growth prospects. According to Barclays, **Hess (HES, $58)** will increase its production capacity by an average of 2.4% a year through 2012. But J.P. Morgan's LaMotte believes the company's holdings in Brazil and West Africa give it the potential to far surpass that estimate. "When you look at exploration upside, Hess has considerably more than any other company," he says. **Marathon Oil (MRO, $28),** which Barclays expects to boost production by a robust 4.3% this year, is a particular favorite of Ed Maran, the manager of the $2.1 billion Thornburg Value Fund. "It's trading far too cheap relative to the value of its assets," says Maran.

Bubbling Up?

After a long fall, oil could be ready to rise again.



But perhaps the most impressive growth story in the oil world belongs to **Petróleo Brasileiro (PBR, $34),** or Petrobras, the giant Brazilian oil company based in Rio de Janeiro. Over the past two years the company has announced three deepwater discoveries that are potential mega-fields. While they'll take years to develop, they have vast potential. "If you look across all the companies you can buy as an oil investor, there's only a handful of companies that can grow organically, and we like Petrobras the most," says Cheng of Barclays. He also points out that while new investors have flocked to the company's common stock, they have largely ignored its preferred shares **(PBR-A, $34),** which currently trade at a significant discount. If you're going to play the oil rebound, you might as well start from the lowest point possible.

TO PICK WINNERS, SAY ANALYSTS, FOLLOW THE PRODUCTION GROWTH.

IPO WATCH

A LANGUAGE SOFTWARE FIRM TRIES A SCARY MARKET.

IF YOU'RE wondering why you've been seing all the TV ads for language-teaching software company Rosetta Stone (in one, swimming stud Michael Phelps crows about learning Chinese before the Beijing Olympics), three letters explain it: IPO.

As *Fortune* went to press, the company was boldly planning to conduct an initial public offering in mid-April, in what would be just the third U.S. IPO this year, after Mead Johnson Nutrition and Chinese videogame maker Changyou.com. If its shares are priced in the middle of the proposed range of $15 to $17, Rosetta Stone would have a market value of $341 million.

The software maker hasn't been slowed by the downturn. In 2008, according to SEC filings, Rosetta Stone booked revenues of $209.4 million, a 52% increase over 2007. Plus, it's profitable, with net income of $13.9 million last year. At $16, the stock would trade at a P/E of 23 - not bad for such torrid growth. For investors willing to take a risk, those numbers translate to a buy.

—*Michael V.* Cope/and

KIMES, Mina. Time to Bet on Oil Again. **Fortune**, Amsterdan, v. 159, n. 8, p. 23-25, 27 April. 2009.