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Beyond The Oil Price: Financial Policies And Cost Savings Are Critical For Oil Majors' Ratings

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The business model employed by the oil majors involves investing through cycles to generate long-term earnings. This can mean majors strengthening their balance sheets when oil prices rise in order to continue investing when prices are lower. Indeed, locking in lower costs when oil prices dip can be one way of improving returns. But companies' financial policies are also a key determinant of leverage. As oil prices remained high over 2011-2014, oil majors did not deleverage their balance sheets. And since prices collapsed from 2014, they have made relatively few final investment decisions on major new projects. The modest improvement in crude oil prices year-to-date (YTD) in 2017 compared with 2016 (Brent average of $51/barrel [bbl] YTD versus $44/bbl in 2016), reflects the support from the OPEC and Russian agreement to constrain production, but hardly offers a get-out-of-jail-free card for ratings.

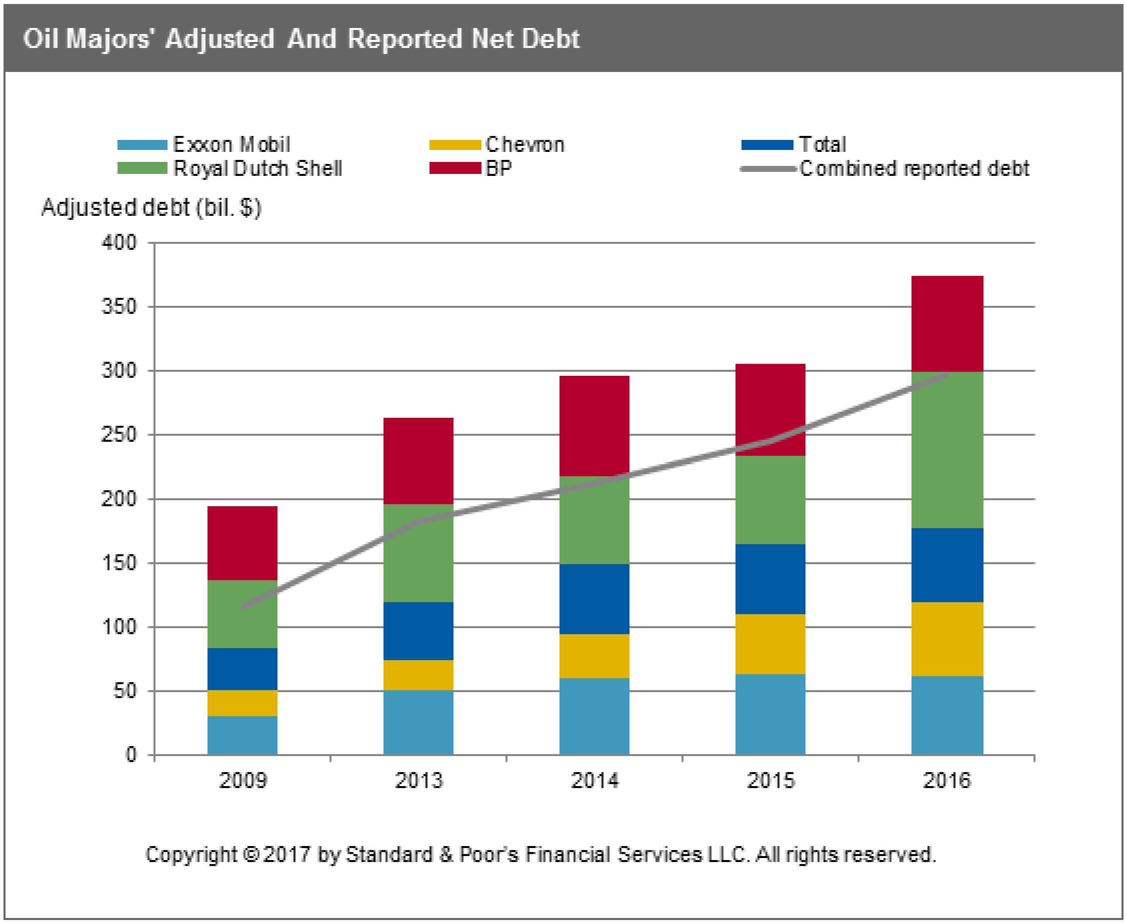
Overview

- We believe oil prices will likely remain under pressure in 2017, despite OPEC and Russia's agreement in May to maintain their oil production cuts for a further nine months.
- Based on our adjusted leverage measures, all of the oil supermajors were overleveraged for their ratings at year-end 2016.
- Our ratings already assume improvement in credit metrics from their trough in 2016, with the negative outlooks on three of the five supermajors reflecting potential downgrades if sufficient improvement isn't likely to transpire.
- However, oil majors are making significant progress in rebalancing their costs and are now signaling breakeven prices of $50-$55 a barrel.
- Importantly, most greenfield developments should have much lower breakeven levels, which should facilitate positive cash flow for oil majors.

In this cycle, the five supermajors--ExxonMobil Corp, Chevron Corp., Total S.A., Royal Dutch Shell PLC, and BP PLC--did not build up headroom in the credit ratings assigned by S&P Global Ratings or debt capacity on their balance sheets, even after three years of crude oil prices exceeding $100/bbl. This was a result of industry cost inflation, correspondingly heavy capital investment, and shareholder distributions, which ongoing cash generation did not always cover. These factors accumulated over the 10 years to 2015 and particularly dampened the benefit of high oil prices for funds from operations (FFO) and free cash flow over mid-2011 to mid-2014.

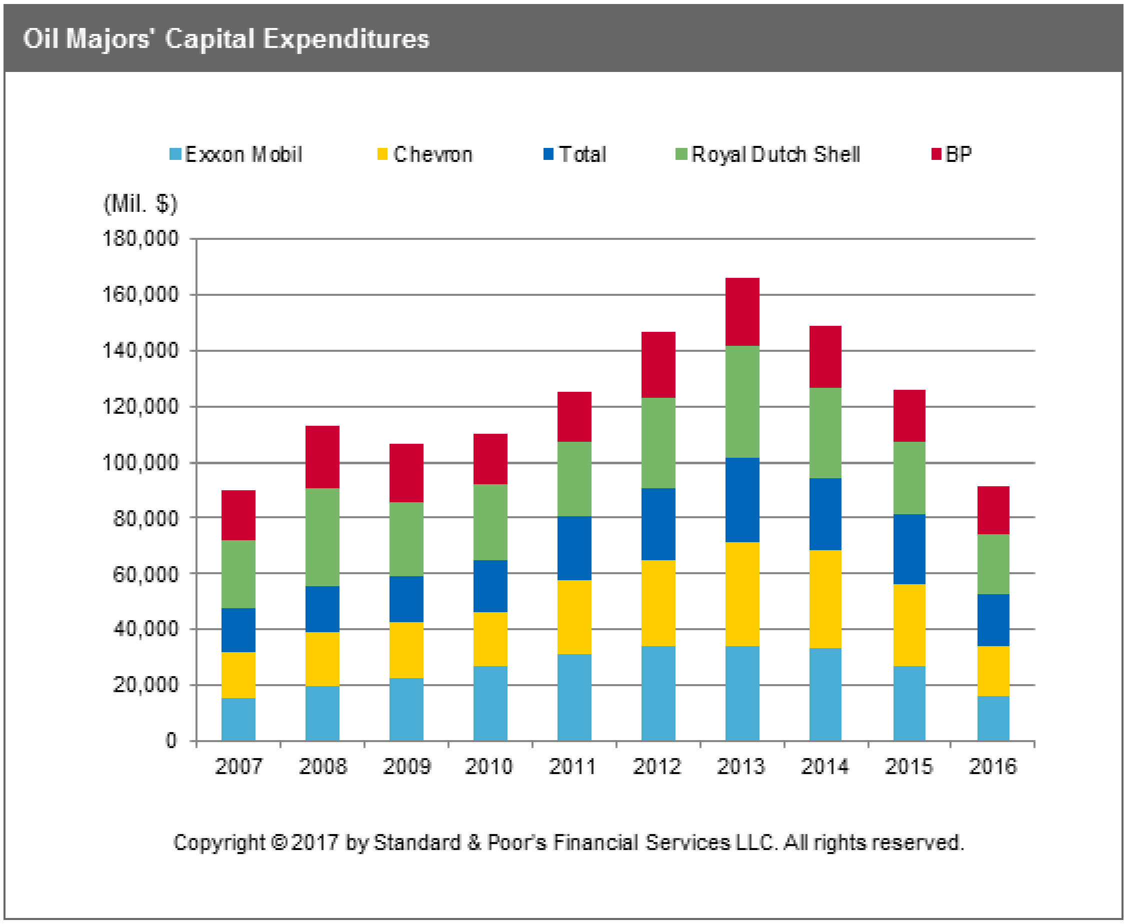
As importantly, since 2014, the cuts in costs, capital expenditures (capex), and shareholder distributions have not sufficiently compensated for weaker operating cash flow. Supermajors' debt levels and credit metrics have suffered significantly, with aggregate debt reaching nearly $300 billion in 2014, up from just under $200 billion in 2009 (our adjusted basis calculation; see chart 1). By end-2016, aggregate debt had increased to $375 billion, remaining unchanged overall in first quarter 2017 (the trend is similar on a reported net debt basis).

Chart 1



Consequently, the supermajors' balance sheets weren't well prepared for the 2014 and ongoing sector downturn. Investment in major projects persisted, and self-imposed capital constraints for many only had a significant impact in late 2015. Some companies such as BP, fortuitously had projects completing as oil prices fell. Others, such as Chevron, were effectively committed to conclude major projects and keep investing as prices kept falling and remained low.

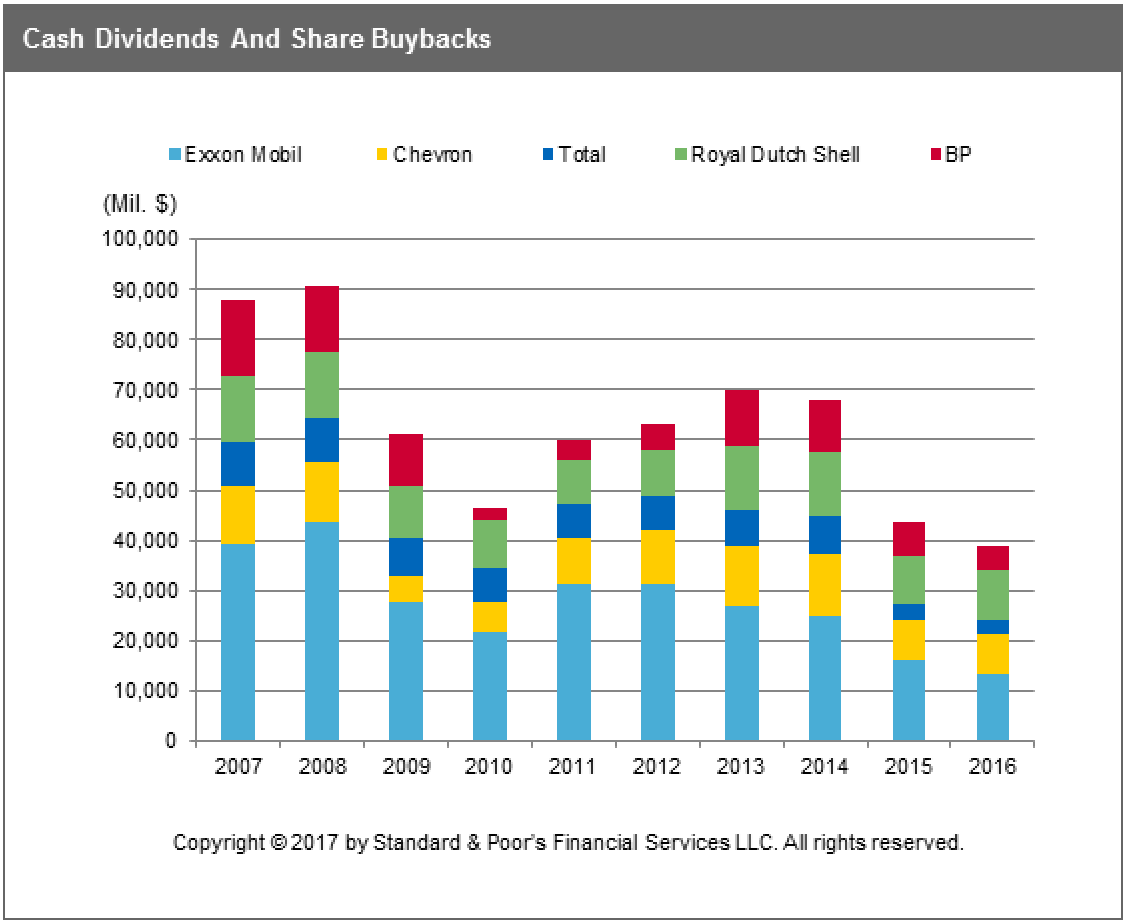
Chart 2



Shareholder Distributions Constrain Debt Reduction

Shareholder distributions also remain a drain on company cash, especially on a cumulative basis. The supermajors have maintained--or even increased--nominal dividend payout levels throughout the downturn (see chart 3). They have curtailed share buybacks, and in Europe, have moderated net debt increases through scrip programs. However, in contrast to the large mining companies, the largest oil majors have not reset their underlying financial policies to flex cash distributions in line with their near-term cash generation. Companies pay scrip dividends in new shares rather than cash, typically at the shareholders' election. In the short run, this conserves cash in the group, which is positive. For equityholders, particularly those that take dividends in cash, the dilution resulting from the issuance of new shares (to shareholders taking the scrip option) can become an increasingly relevant consideration. This could incentivize more material share buybacks in the future.

Chart 3



The majors' balance sheets have borne the consequent funding needs as a result of operating cash flows not covering investment and shareholder returns. Material disposals have been the main reason for net debt not increasing more, with working capital releases due to lower prices constituting less material support. International oil companies (IOC) have not raised any external common equity capital. Total has issued €10 billion of preferred equity, which we treat as intermediate (50%) equity content hybrids.

We continue to see reduced investment in the long-term cash generating assets of a company in order to maintain shareholder distributions as a negative factor for ratings. This is particularly the case when absolute debt levels and leverage metrics are deteriorating or weak. Similarly, group asset portfolio changes, disposals, and the sale of part or all of an oil interest to a third party--known as farm downs--are business-as-usual activities for the majors. But, relying on disposals--rather than operating cash generation--to fund shareholder distributions is likewise not supportive for ratings or necessarily sustainable as a policy.

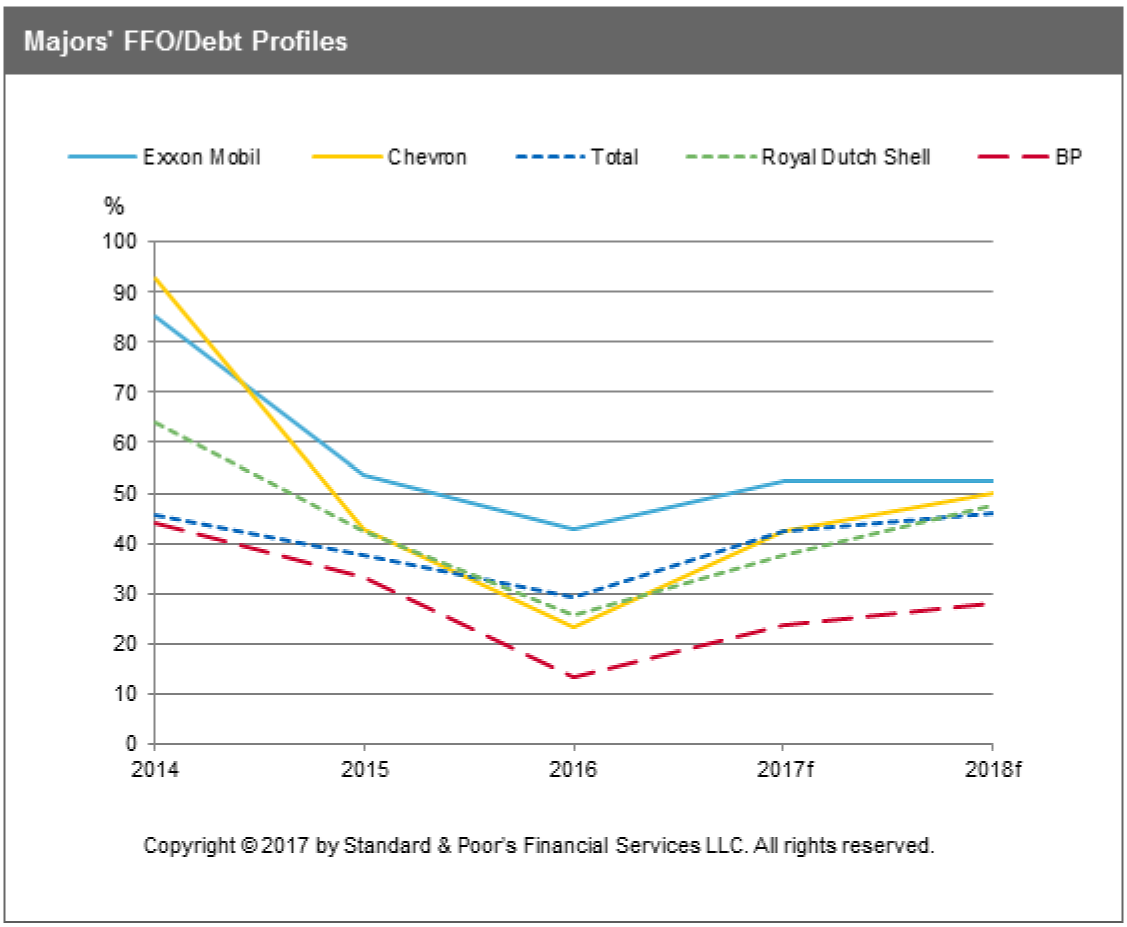
Negative Outlooks Prevail, Despite Signs Of Improving Credit Metrics

In 2014 and 2015 we assigned negative outlooks to many majors. Downgrades of all of the supermajors by one notch followed in 2016 as the downturn dragged on and credit metrics strayed too far from our guidance for the respective ratings. We downgraded Royal Dutch Shell by a further notch as a result of the acquisition of BG Group PLC. An outlook points to a potentially different rating under a different scenario from our base case.

Our negative outlooks on three of the five supermajors--ExxonMobil, Chevron, and Total--reflect weak credit metrics for their ratings at year-end 2016 and the slower than expected improvement. This low starting point may imply a difficult potential recovery to average levels of FFO to debt (FFO/D) and free cash flow that we would consider to be more commensurate with the ratings (see chart 4).

Nonetheless, for now, our base case forecasts that underpin our financial risk assessments and ratings imply strengthening credit metrics in 2017 and 2018 under our current assumptions of Brent and WTI averaging $50/bbl for the remainder of 2017 and 2018 and $55/bbl from 2019. We assume refining margins in 2017 are at least in line with 2016. They have been modestly stronger in most areas of the majors' operations in the first half of 2017.

Chart 4



Modest Oil Price Recovery Is Not Enough To Support Ratings Upgrades

Modestly stronger oil prices and refining margins in 2017 so far have led to a gradual improvement in both operating performance and credit metrics. Notably, first-quarter 2016 was a particularly weak period, so year-on-year comparisons with first-quarter 2017 can exaggerate the improvement so far. To a limited extent, production sharing agreements have generally supported operating cash flow as prices fell dramatically (due to higher entitlement barrels), but there is limited disclosure and visibility about the contractual dynamics should prices rise and how material the impact of lower cost recovery barrels could be for fields where investment has been low or reduced.

Importantly, our ratings factor in the continued benefits of previous cost saving schemes, as well as a structural focus across the industry on standardization, safe but not gold-plated engineering solutions, and improved logistics and coordination. A relatively moderate recovery in oil prices may facilitate these changes better than a rapid rebound. We do not currently anticipate seeing the rebound in costs seen in North America in first-quarter 2017 globally for the majors, partly because of the extent of the earlier drop in service pricing and activity from 2015 in the U.S. By 2016, majors had shown significant success in cutting both costs and capex. As an example, in upstream, unit lifting costs for ExxonMobil, Royal Dutch Shell, and Total were between 26% to 32% lower in 2016 than 2013, exploration spending (operating expenses [opex] and capex) was down between 41% and 71%, and more automatically variable expenses like royalties and non-corporate taxes were down by more than 60% where disclosed. Overall, BP is targeting breakeven costs after capex and dividends of $55/bbl in 2017, trending to below $40/bbl by 2021. Also, companies are targeting lower breakeven points than the 2016 average level for the ongoing costs from projects coming onstream. We understand this partly reflects upfront investment representing a larger proportion of all-in costs and lower unit costs.

Given the ramp-up in costs prior to 2015, we believe a rebasing of cost and capex levels is important for the majors to have sufficiently resilient and flexible operating models, should prices remain low or soften further.

We typically focus on FFO/D as a key credit metric, although D/EBITDA can be informative on a pre-exploration and pre-tax basis. Our financial risk assessments also factor in the capital intensity of the industry and the propensity to maintain material dividend distributions, even in a harsh downturn.

We note a discrepancy between the balance sheet gearing based metrics many majors disclose and use to communicate financial policy frameworks and the cash flow based leverage metrics we focus on for our ratings analysis. Some companies' gearing ranges could span several possible ratings and we recognize that companies comply with their frameworks, but breach our rating thresholds.

Table 1 highlights both the extent of the deviation from our rating thresholds in 2016, but also the more moderate improvement required in 2017 for metrics to approach levels that we consider to be commensurate with the thresholds. Importantly, we assess ratios and financial profiles on a multi-year, weighted-average basis, typically over five years. For the five companies combined, compared with actual 2016 results, debt would have to have totaled about $140 billion or 37% lower to meet the respective rating thresholds in 2016 alone. Alternatively, FFO would have needed to be $56 billion (57%) higher. For single-year 2017, given our forecast recovery in FFO, debt would need to reduce by a more modest $57 billion (15%) from 2016 levels for 2017 metrics to be in line with our multi-year average thresholds for each rating. Arithmetically, leverage means a billion dollars of FFO has a greater impact on ratios than a billion dollars of debt.

Table 1

Year-End 2016 Credit Metrics And Implied Improvement To Meet Our Multi-Year Rating Thresholds

	Exxon Mobil Corp.	Chevron Corp.	Total S.A.	Royal Dutch Shell PLC	BP PLC
Rating	AA+/Negative/A-1+	AA-/Negative/A-1+	A+/Negative/A-1	A/Positive/A-1	A-/Stable/A-2
Financial risk premium	Modest	Intermediate	Intermediate	Significant	Significant
S&P threshold for FFO/debt (%)	60	45	45	35	30
FFO/debt in 2016 (%)	43	23	29	26	14
To reach the threshold if 2016 FFO remains unchanged, the debt has to decrease by	18	28	21	32	42
% of 2016 adjusted debt	(28)	(48)	(35)	(27)	(55)
To reach the threshold if 2016 debt remains unchanged, the FFO has to increase by	11	12	9	11	12
% of 2016 FFO	40	93	54	36	122
To reach the threshold if 2017 FFO remains unchanged, the debt has to decrease by	9	5	9	13	22
% of 2016 adjusted debt	(14)	(9)	(15)	(11)	(28)
Basis of company's gearing range	-	-	ND/E	ND/Capital	ND/Capital
Company's gearing range	-	-	20%-30%	0%-30%	20%-30%
Company's gearing (%) at March 31, 2017 (Dec. 31, 2016)	(18.4) ND/Capital	(24.1) TD/Capital	22.7 (27.1)	27.2 (28.0)	28.0 (26.8)

FFO--Funds from operations. ND/E--Net debt to equity. ND/Capital--Net debt to capital (debt plus equity). TD/Capital--Total debt to capital. Net debt to capital for Chevron was about 20% at March 31, 2017 and 21.2% at Dec. 31, 2016. Net debt to capital for Total was 18.5% at March 31, 2017 and 21.3% at Dec.31, 2016. FFO and FFO/D for BP in 2016 are particularly low due to fourth quarter Gulf of Mexico payments.

Beyond Our Base Case Ratings Forecasts

If oil prices persistently trend below our price assumptions ($50/bbl on average until the end of 2018), downgrade pressure for many ratings would increase without material and sufficient further cost and capex efficiencies, disposals, or other countermeasures against weak credit metrics for a sustained period.

By contrast, unless prices rebound strongly to sustainably higher levels, for most majors--except for Shell with a positive outlook after its 2016 outperformance--it remains to be seen if credit metrics can recover sufficiently in the near term for rating upside to become likely. For others, more resilient moderately higher prices over 2017 and 2018 could underpin the recovery in credit metrics that we assume, and support potential outlook revisions to stable from negative. This recovery would be subject to management decisions and timing on deleveraging, shareholder distributions, and increased organic or inorganic investment.

IOCs' financial policy decisions, particularly about capital allocation, may become more important for ratings now negative cash flows are moderating. We have seen some modest dividend increases already. Companies are likely to take advantage of the downturn and lower their costs to lock-in profitability on some field developments. We understand companies often screen projects at the engineering stage for viability at $40/bbl or $50/bbl. It could be economically rational to increase debt to do this and capital markets appear to be very much open for the majors to fund such investment at relatively low current rates. BP pointed to investments and acquisitions in continental Africa as a reason for the increase in its breakeven costs in 2017 versus 2016. Acquisitions could also become more common across the sector. Alternatively, companies may prioritize debt reduction to rebuild financial strength to plan for an uncertain future. The course that companies choose, as much as the oil price, could signal at what level ratings should most appropriately capture the respective and prospective credit risks for these massive groups.

Related Research

- Summary: BP PLC, June 20, 2017
- Exxon Mobil Corp. Outlook Revised To Negative From Stable On Weak Credit Measures; Ratings Affirmed, May 24, 2017
- Oil And Gas Major Total 'A+/A-1' Ratings Affirmed; Outlook Remains Negative Following Full-Year 2016 Results, Feb. 27, 2017
- Outlook On Royal Dutch Shell Revised To Positive On Expected Stronger Credit Metrics, 'A/A-1' Ratings Affirmed, Feb. 14, 2017
- International Oil Majors Test The Limits Of Integration In 2016, Sept. 15, 2016
- Chevron Corp. Rating Outlook Revised To Negative From Stable On Revised Operating Assumptions; 'AA-' Rating Affirmed, Sept. 13, 2016
- Industry Top Trends 2017: Oil & Gas, Feb. 15, 2017
- S&P Global Ratings Raises Its Oil And Natural Gas Prices Assumptions For 2017, Dec. 14, 2016

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