COMMENTARY

September 20, 2019

Dear Clients and colleagues:

Geopolitical events are unpredictable; an example of this is the recent drone attacks in Saudi Arabia's oil fields. The attacks on Aramco facilities affected 5.7 million bpd of Saudi output (6% of the global supply). Global crude inventories will only cushion against supply shortages for a short while. Estimated inventories amount to 6.1 billion barrels, or 61 days of global demand.

With 2 million barrels back online, full ramp up is estimated to be by November. As political tensions escalate, the sophistication of the drone attacks, which occurred deep in Saudi territory, will create a permanent geopolitical risk premium for oil. According to many analysts, this premium could range around $4 per barrel.

In the event of a long-term supply shortage, economic disruption could be felt in the Middle East as well as in many Asian countries including China; countries that have increased their reliance on Saudi oil over the years. In the US, 90% of oil imports are from Canada. North American industries requiring oil flow to run their operations should be unaffected locally. The EU imports 6.6% of its crude oil from Saudi Arabia and 27.3% from Russia, therefore dependency on Russia should increase. With more than 30% of its oil coming from Saudi Arabia, the country in our universe that is most at risk of economic disruption is Japan.

Global Alpha measures geopolitical risk as part of its risk mitigation strategy in portfolio construction. We attempt to reduce factor risk (risks related to country, currency, style and industry) versus non-factor risks (company risks). We achieve this through optimal diversification in currencies, countries, industries and sectors.

Geopolitical events add risk mostly under factor risk as they typically affect macroeconomics. However, if small in scale, they can fall under non-factor risks, for example, regional events such as in November 2018 when Colorado voted against strong regulations that would have made it very difficult to explore oil and gas in the state of Colorado. As this geopolitical event did not affect an entire industry or country, it is not considered to be a factor risk but a non factor risk specific to oil and gas companies in Colorado.

Continuing with energy as an example, on a daily basis we keep a watchful eye on our holdings related to energy and if they go up or down compared to the indexes oil and gas components on an contribution basis. If our names consistently have a similar return contribution as the indexes oil and gas names (on typical days when corporate news is low), we probably have a low factor risk environment for our oil and gas sector.

Ultimately, when geopolitical events like the Aramco attack occur, our oil stocks return contribution should be similar to the indexes oil stocks return contribution under the same low factor risk environment.

Global Alpha remains exposed to the energy sector; our index is comprised of 4% energy stocks and a plethora of industrial stocks closely related to energy activity. Core criteria that drive our search include companies with a low cost production profile, low replenishment costs, better balance sheets, and competitive advantages in downstream or transportation arrangements, stable management and better ESG scores.

Global Alpha owns Arc Resources. (ARX.CN, Market cap $2.6B)
Beta 0.90

Arc Resources is a Canadian oil and gas producer operating in the Montney and Pembina oil fields. Revenues split is 40% oil, 39% condensate and 21% natural gas liquids. Production totals 140k of barrel equivalent oil per day. The dividend yield is 8% and the debt/EBITDA ratio is 1.

The company has completed 75% of a large infrastructure spend that will increase its leading position as a low cost producer. With $360M left to spend in the next two years (from $600M over the last five), the company will then reduce its capex expenditures for strong cash flow recovery. Dividend payments and growth capex are presently below production and managerial costs, already giving it leading operations metrics before infrastructure improvements. The CEO is an engineer and has been with the company since 1998.

Global Alpha also holds Unit Corp. (UNT.UN, Market Cap $221M)
Beta 1.78

Unit is an integrated oil & gas company with oil production, contract drilling and midstream business segments. Their assets are located onshore in continental US. Production breaks down as follows: Natural Gas Liquids 25%, Oil 22%, and Gas 53%. Unit is also vertically integrated and further has a service division that increases diversification.

The energy sector is cyclical. Oil and gas service companies are not immune to this cyclicality even if their business model often have a technology thematic undertone. Technology has been the key factor of success in shale gas recovery and oil and gas transformation remains a highly complex and technologically advanced ecosystem.

Global Alpha holds positions in leading oil services companies. Do these companies help us contain the risk of a sharp change in oil prices during a geopolitical risk event? Time will tell. A second way of following volatility is stock beta. Mindful that a stock beta varies through time, we can look at the Beta of our companies compared to the MSCI oil and gas index.

Thermon Group (THR.US Market cap $783M)
Beta 0.59

Thermon is an equipment service company supplying heat management solutions to the oil and gas, power generation and chemical markets. Thermon specializes in providing complete flow assurance, process heating, temperature maintenance, freeze protection and environmental monitoring solutions. The geographical mix is 37% Americas (excluding Canada), 31% Canada, 22% EMEA & Russia, Asia 10%. Market share: 20% Thermon, 30% nVent, 4% Bartec, 3% Chromalox, 47% others. Revenue mix is 38% Oil and Gas, 14% Chemical Processing, 7% Power Generation and 6% Transportation.

Schoeller Bleckmann Oilfield (SBO.AV, Market cap 977M EUR)
Beta 1.34

Global market leader for high-precision components, the company providing nonmagnetic drill string components to oil field service companies engaged in directional drilling. It also manufactures drilling motors and drilling tools used for extracting oil and offers repair and maintenance services. The majority of its customer base is in the US (80%) and Europe. Clients include Schlumberger, Halliburton, Baker Hughes. Sales mix is split in high precision component 53%, and oilfield supplies and services 46%.

Tecnicas Reunidas (TRE.SM Market Cap 1.3B EUR)
Beta 0.78

Tecnicas Reunidas is an international contractor in the field of management, engineering, design, procurement, construction and commissioning of complex industrial plants for a wide range of clients all across the globe. There is a focus on three business: oil & natural gas (84.5%), energy & water (13.5%), other industries (2%).

Based on the Beta review, Unit Corp and Scholler Bleckmann show positive correlation to the oil and gas index. This also seems normal as Tecnicas Reunidas and Thermon business revenues are derived from refining expenditures versus oil production.

Further, only small weights in both high beta Unit Corp and Scholler Bleckmann could help the portfolio to mitigate risks related to oil and gas price volatility brought either by geopolitical risk and other non-factor risk.

Have a great weekend.

The Global Alpha team