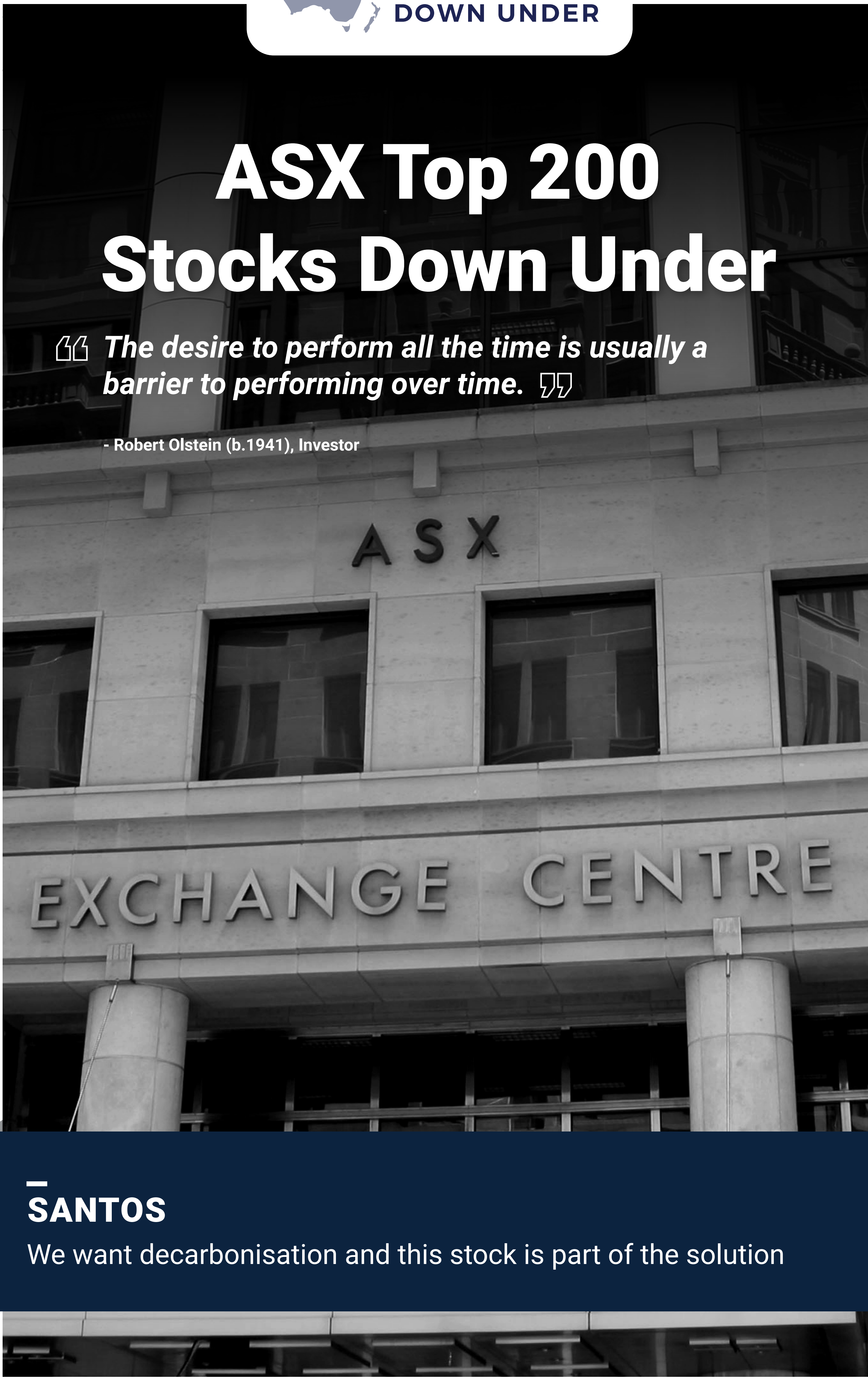
STOCKS DOWN UNDER

14 MARCH 2022

ASX Top 200 Stocks Down Under

> *The desire to perform all the time is usually a barrier to performing over time.*

- Robert Olstein (b.1941), Investor



SANTOS

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Stocks Down Under rating: ★★★★

ASX: STO
Market cap: A$25.6BN

52-week range: A$5.84 / A$8.37
Share price: A$7.57

Oil prices have hit highs not seen for nearly a decade, yet Santos is still trading below its pre-Corona Crash highs, even following the Oil Search merger. With the push to decarbonise, some investors may view Santos (ASX: STO) as a pariah being one of Australia's largest gas companies. But we think even if the company is part of the problem, it is also part of the solution, particularly since its merger with Oil Search, which has given it further exposure to LNG and cemented its position as an energy giant.

Share price chart

Source: Tradingview

An energy giant that has kept getting bigger

Santos was founded in 1954 in South Australia, made its first significant discovery of natural gas in the Cooper Basin in 1963, has remained there to this very day and has picked up additional projects over the years. Last year, it merged with Oil Search, cementing its position as one of the Top 2 petroleum companies on the ASX together with Woodside Petroleum (ASX:WPL).

Santos has assets across Australia, East Timor, PNG and Alaska. It has best estimate contingent resources of 4,983MMboe (millions of barrels of oil equivalent) and it produced 116m barrels of oil equivalent in 2021. Santos produces energy and sells it to energy companies that provide it to consumers. Santos sells into the domestic energy market and export markets such as South Korea, Japan and China.

In 2021, it sold 104.2mmboe (excluding Oil Search's assets), generated revenues of US$4.7bn, made an underlying EBITDAX of $2.8bn and profit of $946m – up 39%, 48% and 230% from the year before respectively. The company expects to sell 110-120mmboe in FY22, although production will be slightly lower after selling a 25% stake in the Bayu-Undan field in East Timor.

Santos at the mercy of energy prices

As a company in the petroleum space, Santos is vulnerable to shifting oil prices. During the Corona Crash, oil prices notoriously crashed below zero due to substantial oversupply because of the shutdown of global economic activity. Santos swung to a net loss of US$357m. But oil prices have gradually risen from those lows and have surpassed US$100 once again for the first time since 2014 – thanks to the war in Ukraine, which has triggered a fear of a global supply crunch given Russia is a major oil producer.

Santos delivered a free cash flow breakeven level of US$21 per barrel in 2021 and is expecting US$25 per barrel in 2025. Santos won't see an immediate benefit from oil prices rising over $100 per barrel, because much of its gas is sold on long-term contract prices linked to crude oil, but the company is benefitting from prices seen for much of 2021.

Even though Santos is more exposed to LNG post the Oil Search merger , it will still be vulnerable to oil price fluctuations. But we think LNG prices will be less volatile than crude oil for some time yet, because, in many respects, LNG markets are predominantly regional rather than global. But like oil, LNG prices have been booming. Santos recorded an averaged realised LNG price of $US10.36 per million British thermal units, which was more than double the price at the same time last year.

Santos is a cheap company, but should it be?

Consensus estimates have forecasted US$7.0bn in revenues in 2022 and EBITDA of US$4.9bn in 2022. However, both figures are forecast to drop in 2023, to US$6.3bn and US$4.5bn respectively. This means the company is trading at 4.8x FY22 EV/EBIDA and 5.3x FY23 EV/EBITDA. On a P/E basis, this company trades at 8.2x for FY22 and 9.7x for FY23.

Woodside Petroleum (ASX: WPL) is trading roughly the same on an EV/EBITDA basis, but is more expensive on a P/E basis at 9.7x for FY22 and 12.9x for FY23. Fellow South Australian company Beach Energy (ASX: BPT) is cheaper than both companies at 3.5x and 3.3x EV/EBITDA for FY22 and FY23 respectively, and 7.9x and 7.4x P/E for FY22 and FY23 respectively.

Santos is also part of the solution

Nevertheless, all three companies are below pre-COVID highs, albeit Santos only narrowly. We believe oil companies have been under pressure from investors having significant fossil fuel exposure. Such companies consequently contribute to Australia's greenhouse gas emissions and their cash flows are seemingly vulnerable as other companies transition to greener energy. It is true that the continued windfall from high oil prices will not last forever and the world needs to decarbonise. At the same time, we believe investors are disregarding the impact that gas companies like Santos can and will have on the transition because natural gas and LNG are less emission intensive than oil.

Santos is aiming to cut emissions by 26-30% by 2030 and to net-zero by 2040. One way the company is striving for this is diversifying into carbon capture. Last month, Santos booked 100m tonnes of CO2 storage resource in the Cooper Basin on top of the 1.7m tonne per annum Moomba carbon capture and storage (CCS) project, which it made a final investment decision on last year. Eventually, the company wants to produce green hydrogen from the Cooper Basin. Even though there will be significant capital expenditure, we think Santos has substantial free cash flow for the time being and has the scope to sell assets while still maintaining a robust portfolio.

For the third time in a row, it's four stars from us and with even more enthusiasm than the first two times we wrote about the company in June 2020 and June 2021. With oil prices now at near-decade highs and with Santos leveraged to handle the transition to renewable energy, we believe shareholders have good things to look forward to.

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