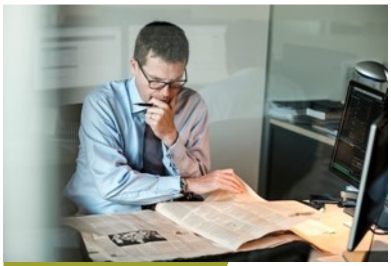

Friday Morning Coffee

European Capital Partners

Nr. 101 — Total recall

We have been asked over the last days on how we exploit the current weakness in the oil price.

For the ones believing in a swift oil price recovery, a simple and easily implementable trade is going long an oil ETF. We have two concerns with this strategy. First, as value investors we focus on earning power, namely the capacity of our investment to generate discretionary free cash flow. Unfortunately, a commodity does not generate cash flows and the return realized on owning it is simply the result of where we see the price in the future. Forecasting demand and supply of oil is not our business and we have not met anyone lately who had accurately predicted this year's fall in the oil price, the result of an external demand choc due to COVID-19 and a supply choc due to the Saudis decision to massively increase production. Secondly, we think that ETF's also have risks inherent to them as they synthetically reproduce the price of the underlying, in this case the oil price. The purpose of many of these ETF's is to track the front-month oil futures contract and not the "spot", or cash price of oil. This may eventually lead to nasty surprises for investors in periods of market stress.

The price dislocation of the oil price became extreme this week as the WTI front month (May delivery) traded as low as minus USD40/bbl. As the oil future dropped below 0, investors were momentarily being paid for storing oil! Unless being able to physically store barrels of oil in the backyard, it appeared hard to exploit this opportunity. One of the first beneficiaries are however the oil tanker companies like the Belgian Euronav. For as long there is a huge spread between Dated Brent and Brent June contract, the so-called super contango situation, it is interesting to buy oil now, store it and sell it forward in June. If that strategy works, shipping rates for tankers will be at highs. For Euronav that could result in the company "overearning" significantly. Some analysts think the company will be able to generate free cash flows over the next 2 years totalling 100% and dividends totalling 60% its whole current market capitalization. Warren Buffett has famously quoted "I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years.". We are not convinced we would want to stay invested in an oil tanker company and ride all the storms over the next 5 years. While we find the short-term investment opportunity enticing, we concluded not to pursue this idea.

Instead we revisited one of our previously rejected investment cases, the one in the French integrated oil and gas company Total. We had already analysed the company in October last year, but we rejected it for valuation reasons. Here we are 6 months later and a stock price 37% lower as of Tuesday this week.

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Source: Bloomberg

There is a lot we fundamentally like about Total: the strong and experienced management team, the vertical integration, the diversification into renewables, the strong free cash flow generation, the strict cost control, and the strong balance sheet. The best thing the company can do if oil prices fall below production cost is stopping production while the price hurricane is passing. That will hurt earnings short term but not impair the long-term earning power of Total. **The company has been particularly good at lowering its break-even point by lowering capital expenditures. The world still needs oil and Total is well positioned for that. For next year, the estimated dividend yield is 8.7% and the company trades at 4.6 times EBITDA on Bloomberg figures. We have built a position in our European value strategy.**

I wish you a nice weekend,

Léon Kirch, CFA

Partner & Chief Investment Officer

April 24 th, 2020