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MACROCOSM

PIF the Magic Aramco IPO

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Read the prospectus: twilight in the desert, or dawn? Or reaction to the "Obama doctrine"?

Following a 50%-plus bull market off the February 11 bottom, crude oil is experiencing the correction we anticipated (see "Oil's Bull Market in a Month" March 15, 2016). The narrative surrounding the correction has been animated by a wide-ranging Bloomberg interview with Saudi Crown Prince Mohammed bin Salman, the young defense minister who has positioned himself as an agent of sweeping reform for the Saudi economy and culture (see "Oil: Priced for Perfection in an Imperfect World" January 20, 2016). *While there are many complexities and unknowns here, we think ultimately Prince Mohammed's plans will be supportive for oil prices, and we reiterate our belief that the January and February selling climaxes are a durable cyclical double-bottom.*

- In the Bloomberg interview, Prince Mohammed said that Saudi Arabia would not freeze oil production unless Iran did so as well.
- On the face of it, this contradicts hints to the contrary from OPEC two weeks ago, right when oil's recovery from its January/February double-bottom was at its peak. But we have said all along during the development of market buzz about the freeze, surely it's a non-starter considering that Iran is hell-bent to increase production in the wake of the lifting of international sanctions in January.
- And beyond Iran, a freeze at today's record production levels doesn't buy much relief for glutted oil markets. Even relief from the risk of even higher non-Iran OPEC production doesn't count for much, considering that it has been generally flat for months anyway (again, see "Oil's Bull Market in a Month").
- Of much more interest is Prince Mohammed's plan to IPO "less than 5 per cent" of Saudi Aramco – the state-owned Saudi Arabian Oil Company – including upstream, midstream and downstream assets, and put the residual shares into the Public Investment Fund (PIF), the Kingdom's sovereign wealth fund.
- We are surprised that upstream assets – the oil itself, the Saudi family jewels – are on the table. When an Aramco IPO was first hinted at, we had expected only downstream assets to be on offer (see "Oil: Priced for Perfection in an Imperfect World").
- *Putting upstream assets on the block would presumably require that rigorous disclosures about them be made in the offering's prospectus. This is a wild-card for the perception of long-term supply in global oil markets.*

Update to strategic view

OIL: Prince Mohammed's rejection of a production freeze, and his revelation of Saudi's plans to IPO Saudi Aramco and put it in PIF, the Kingdom's sovereign wealth fund, is driving an oil correction that was inevitable anyway. The freeze has always been irrelevant, with non-Iran OPEC production at record highs, but flat now for months. The IPO, which would include reserves, will drive rigorous disclosure of the size and nature of those reserves for the first time in 35 years – it's a wild card in terms of market perception, but it's in Saudi's interest to manage the disclosure to maximize value. The IPO turns an illiquid and opaquely valued asset into a liquid and transparently valued one, giving Saudi a powerful war chest to survive the oil price-war and regional rivalries in the wake of the destabilizing "Obama doctrine." This highlights what we think are undervalued call options on geopolitical risk embedded in the oil price, especially now that physical supply and demand are finding balance. The bottom is in.

[Strategy dashboard]

- Remember, during the "peak oil" craze in 2008, Matthew Simmons' widely praised book *Twilight in the Desert* argued that Saudi was imminently running out of oil. That seems laughable now (as does much that was said about oil in 2008), with Saudi production at an all-time high, 6% above 2008 levels even after six years of pumping. But nobody could objectively refute Simmons in 2008, because there was no way to access reliable Saudi reserves data. What would the world think if reliable reserves and production cost estimates, filed in the Aramco prospectus, indicate that Saudi could profitably produce oil at $15/barrel for decades to come?
- On the other hand, a prospectus might show that Simmons was only early, not wrong.
- We haven't really had a good look since 1980 when the Saudi government entirely nationalized Aramco. Prior to that, reserves estimates by Chevron and Exxon were considered reliable.
- Assuming that as in most prospectuses the issuer errs on the side of self-interest, then Aramco will wish to portray its reserves at an optimum that makes them seem, on the one hand, quite capacious – and yet, on the other hand, not so *surprisingly* capacious as to depress the price at which they are valued. As always in a pricing calculus, the Saudi's challenge will be to maximize the present value of P * Q (subject to a truth constraint).
- So it's a wild-card that oil markets will have to deal with over the next couple of years.
- *Why would the Kingdom wish to IPO Aramco in the first place?*
- *We suppose it could be a bet that Saudi doesn't see much of a future for oil, and wants out. But we don't see how selling 5% of reserves through an IPO accomplishes much in that direction. It's not like Saudi hasn't been selling oil already – for a century. It's what they do. An IPO is just selling it in a securitized form.*
- But it can matter what form things take. In securitized form, otherwise highly illiquid and difficult-to-value assets become liquid and objectively valued by markets, tick-by-tick.
- *In that liquid and objectively valued form, Saudi puts itself in a position to easily raise cash in very large tranches with a series of small secondary offerings, enough to finance fiscal deficits during the present global oil price-war.*
- *And from that position of strength, Saudi is poised to put political and economic pressure on regional rivals.*
- The Kingdom was forced to rethink its geopolitical position in the region starting about a year ago, when Barack Obama gave an interview to the *New York Times* in which he sketched an "Obama Doctrine" allowing the balance of power in the Middle East to find its own level. Obama declared the US is "powerful enough to test these propositions [such as the Iran nuclear deal] without putting ourselves at risk" (see "Oil and the Obama Doctrine" April 10, 2015).
- The announcement of the Iran nuclear deal came three months later (see "Iran: The New New World Oil Order, Volume I" July 20, 2015). Facing now two newly empowered Shia rivals – both Iran and Iraq – the Sunni Saudis started a war in Yemen, bought 600

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Patriot missiles and other armaments, and cut diplomatic relations with Iran.

- Saudi's most effective weapon here is its vast low-cost oil reserves – if it comes to a price-war with Iran and Iraq, Saudi will win. The Aramco IPO is a way to lock-and-load that oil weapon for rapid and efficient deployment in economic combat.
- *So we understand the logic of the IPO. But we don't see any magic in transferring to PIF the residual 95% of Aramco assets not sold to the public.*
- *The Saudi government – that is, the royal family – controls the assets now. And it controls PIF. So when the assets it already controls are put inside a sovereign wealth fund it already controls, nothing has really changed.*
- It doesn't hurt to have Saudi prestige bolstered with breathless headlines about what will be a record-breaking $2 trillion fund.
- And perhaps, by using PIF as a political buffer, the royal family thinks it will be better able to better carry out difficult reforms.
- In a future secular regime of lower oil prices, Saudi citizens will have to be weaned off state largesse. Today, 90% of Saudi citizens are employed by the government with salaries above comparable private sector jobs. They get free health care and schooling, subsidized oil, gas, water, and electricity, interest-free loans for building a house or starting a business – and they pay no taxes.
- Prince Mohammed and his family face a delicate balancing act as he attempts to reduce these perks, and at the same time follow through on opening up the economy to more global competition, and the political and social structure to more personal liberty.
- Perhaps it will smooth the way to have these transitions be seen as the expert technocratic agenda of a seemingly independent fund – rather than austerity imposed by the royal family.

Of course – with oil having rallied more than 50% from the February bottom, any news was bound to be treated as bearish, and so it has been with Prince Mohammed's interview. We see his agenda being neutral on the face of it, but with embedded wild-cards that could make a difference – of indeterminate direction – a year of more down the line.

- To be sure, in the long-run, these evolutions in the way the Kingdom manages its energy assets do affect the long-run reality that there has been a permanent downward shift in the cost of oil production, and a permanent upward increment in the volume and reliability of supply. We stand by our long-standing view that the long-run price for oil, in today's dollars, is a range from $15 to $40 (see, first, "Oilmageddon" December 16, 2014).
- But much technological change has to take place for that to be sustainable (see "The Shale Boom Shifts Into Higher Gear" June 1, 2015). In the meantime, the sustainable range is $45 to $60 – a range the bottom of which we are presently far below.
- And all the while, oil is heir to all the same thousand natural shocks that is always has been – mostly geopolitical.

- *And it is in this sense that Prince Mohammed's interview is most significant. It confirms that Saudi is positioning for a more dangerous regional geopolitical environment, one in which military mistakes are more likely rather than less – and in the Middle East, such mistakes can lead to significant supply and transport disruptions that can shock prices higher.* The possibilities of such events are out-of-the-money call options embedded in the oil price, and we think that even after the big rally following the February bottom, the market has not fully valued those options for a world operating under the "Obama doctrine."
- Since the announcement of the Iran nuclear deal, Iran has ramped up ballistic missile tests, fired at US warships in the Straits of Hormuz, flown drones over US warships, and detained and humiliated US sailors for reportedly entering its waters.
- At the same time, the Iran-financed Houthi insurgency is still holding out in Yemen, and could threaten the passage of 2.4 million barrels per day of oil through the narrow Bab al Mandab Strait in the Gulf of Aden.
- It can even be argued that the Iran nuclear agreement that allowed exports of oil and gas to global markets prompted Russia to get involved in Syria, intensifying a military and humanitarian tragedy that is spilling over into Europe (and European politics) as a wave of migrant refugees. In exchange for supporting the incumbent Bashar Assad government, Russia reportedly pushed Syria to reject a Qatari gas pipeline proposal, and slow down an Iranian pipeline under development – both of which would interfere with Russia's dominance in the European gas market.

With production in the US now having definitively rolled over (see "Data Insights: Oil" March 12, 2016), and with little diminution in global consumption, the core physical supply-and-demand environment is coming into balance. In such a near-equilibrium, there is little margin of error that might otherwise permit the market to ignore the embedded geopolitical risk options in oil prices. Prince Mohammed's vision of Saudi's future plans does nothing to change that supply-and-demand balance – but it does, we believe, point to the market's undervaluation of those options.

- In this environment, the oil price has plenty of room to correct some more in the near-term. But the bottom is in.

Bottom line

Prince Mohammed's rejection of a production freeze, and his revelation of Saudi's plans to IPO Saudi Aramco and put it in PIF, the Kingdom's sovereign wealth fund, is driving an oil correction that was inevitable anyway. The freeze has always been irrelevant, with non-Iran OPEC production at record highs, but flat now for months. The IPO, which would include reserves, will drive rigorous disclosure of the size and nature of those reserves for the first time in 35 years – it's a wild card in terms of market perception, but it's in Saudi's interest to manage the disclosure to maximize value. The IPO turns an illiquid and opaquely valued asset into a liquid and transparently valued one, giving Saudi a powerful war chest to survive the oil price-war and regional rivalries in the wake of the destabilizing “Obama doctrine.” This highlights what we think are undervalued call options on geopolitical risk embedded in the oil price, especially now that physical supply and demand are finding balance. The bottom is in.