MOI GLOBAL

Induced Demand within the Energy Complex

This article is co-authored by William Heard, CEO and CIO of Heard Capital, and Andrew Jesse, a Partner at Heard Capital and head of its energy and industrials practice. The article previews a key aspect of their session at Wide-Moat Investing Summit 2018.

In the latter stages of a bull market, when valuations are generally rich, deep domain expertise can be especially critical in helping an investor recognize misunderstood pockets of the markets where mispriced assets present attractive long-term opportunities. Within even the strongest bull market there are sectors suffering cyclical bear markets, where valuations are low, and appropriately so. These can be good places to find the figurative "baby that's been thrown out with the bathwater."

The prolonged cyclical bear market in the energy sector – one of six permanent, regulated industries where Heard Capital concentrates large, long-term, security-agnostic investments – has punished share prices and valuations across the board. But with the United States producing more natural gas than ever, a deep understanding of the natural gas supply chain reveals a "sweet spot" for companies that are positioned to be the bridge that brings this clean and cheap alternative energy source across the oceans to end-markets around the world. Furthermore, since natural gas end markets typically use the fuel for heating and power generation needs, identifying a quality opportunity within the natural gas supply chain not only can offer value, but the additional benefit of a significant degree of insulation from macroeconomic factors.

Within the energy sector broadly, natural gas has an attractive demand dynamic that is by now generally well understood and factored in by the market. Electric power generation end markets globally are seeing a secular shift, with gas plants taking meaningful market share from other sources such as coal and oil-fired plants. This secular shift is due to a litany of practical reasons (e.g., security of supply), financial reasons (e.g., marginal cost) and environmental reasons (e.g., carbon footprint / air quality) . Importantly, the $/mmbtu cost advantage of natural gas versus other fuel substitutes used in similar end markets is large, even on a "landed basis" (i.e., the all-in delivered cost to the end user, not merely the Henry Hub or comparable price), and even without assuming any particular price for natural gas within a relevant historical range.

But a major technological shift now underway *within* the natural gas supply chain portends a new and different significant shift in market share in which investors can participate. It is a shift from land-based natural gas and related storage and transportation infrastructure, to off-shore natural gas storage, transportation and related services, by means of Floating Liquefied Natural Gas (FLNG) and Floating Storage and Regasification Units (FSRU). We think of the coming market share shift toward FLNG/FSRU as a technological innovation that is creating as area of "induced demand" activity at the upstream end of the natural gas supply chain.

FLNG/FSRU are essentially specialized shipping / transportation assets that allow producers of natural gas and LNG to get their production to overseas end markets. FLNG are shipping vessels or platforms that convert natural gas into LNG at the offshore well site, thereby avoiding the need for large scale development of subsea pipeline infrastructure and onshore liquefaction trains. FSRUs are shipping assets that can store LNG as well as convert LNG to natural gas that meets pipeline specifications for delivery to end users. Compared with shore-based alternatives (i.e., a fixed plant), FRSUs offer flexible, faster and cheaper means to store LNG and convert LNG to natural gas for end uses.

In essence, FLNG/FSRU act as the bridge that gets upstream natural gas resources into the midstream portion of the value chain, where they can then be delivered to end markets and monetized.

Players in this space at times say they are “linking the well to the grid.”

We believe companies significantly exposed to growth in usage of FLNG/FSRU assets and technology will attract demand and market share away from shore-based incumbents, while also retaining the secular benefits of natural gas relative to other fuels, as well as the degree of insulation natural gas provides from macroeconomic factors.

FLNG/FSRU providers enjoy a number competitive advantages over shore-based solutions.

Importantly, FLNG/FSRU is location- and supplier- agnostic. While the US is likely to be a low cost supplier of natural gas for the foreseeable future, FLNG/FSRU providers are not beholden to any one specific geography or formation, and given the mobility of their asset base they are able to continue to play a key role in the LNG value chain regardless of where source gas is produced. Additionally, FSRUs are not subject to the intense competition and potentially difficult and lengthy permitting / approval processes to site new shore-based LNG liquefaction and regasification trains, and instead offer a flexible, fast-track solution to delivering natural gas to market.

FLNG/FSRU also are lower cost and more flexible solutions – and in certain circumstances they are the only viable solution for monetizing gas assets. FSRUs allow producers to avoid the expense of siting, permitting and building shore-based facilities. Meanwhile, FLNG represents a lower cost solution for getting far offshore natural gas assets to market. Furthermore, by avoiding large scale subsea pipeline developments and onshore liquefaction facilities, FLNG in some instances can represent the only solution to free otherwise stranded assets.

The return of dispersion to the equity markets that began in 2016 has been a welcome development for active managers. Earlier this Spring, we commented to our investors that a key difference between the investing environments of 2017 and 2016 was that in 2017, we witnessed dispersion elevated at the intra-sector levels, rather than inter-sector levels. In 2016, the primary driver of return dispersion was sector allocation, that is being in the right “neighborhood” was more often sufficient to generate excess returns. Extending the metaphor, the current dispersion environment now makes excess returns available to managers who can find the right house in the neighborhood: since 2017, we have observed dispersion at the individual sector level, which all else equal, provides a more robust security selection environment for sector specialists with domain expertise.

Having identified the FLNG/FSRU category within the natural gas supply chain as what we believe to be a fundamentally attractive and undervalued neighborhood within the beaten down energy sector, we focus during our Wide-Moat Investing Summit presentation on the house (i.e., company) we have identified as being best positioned to reward shareholders.