

Recommendation: SELL

Target Price until (12/31/2016): \$89

1. Reasons for the Recommendation

Schlumberger (SLB) operates in the oil and gas industry as a servicer in the upstream sector of the industry. With a wide breadth of products and services the company has become an industry leader with proprietary products and a global customer based. Their positioning has gained them access to both conventional and unconventional market plays, resulting in 2014 sales of \$49 billion and net income of \$5.4 billion. SLB's stock hit an all-time high in 2014, with a closing price on 6/30/2014 of \$117.95, which equaled a TTM P/S ratio of around 3. Since 2010, the price of crude oil had been increasing and in June 2014 the price was around \$115 per barrel. SLB was able to capitalize on the high prices as North America, and more specifically the United States, started in 2009 what was to be called the "fracking boom". The fracking boom refers to the fact that high prices for crude oil allowed for unconventional oil and gas extraction methods, like fracking. As such, in 2009 SLB had North American sales of \$3.7 billion, by yearend of 2014 sales were \$16.2 billion; equating to a six year growth rate of over 300% and a per annum growth rate of over 56%¹. The growth in sales revenue for SLB is directly attributed to their role in supporting the quest for US energy independence and the number of drilling rigs, which increased from less than 200 in 2009 to over 1,600 by 2014².

Crude oil ended 2014 at around \$53/barrel and as of 4/17/2015, crude oil was around \$56/barrel. US rig count was down to 954³. The recent drop in oil prices is largely attributed to two factors: OPEC member nations committing to producing oil to gain back market share lost with the fracking boom, and a decrease in global demand in economies like China⁴. These two accused culprits should be of great concern with regards to the investment in SLB. SLB's sales revenue is directly affected by the price and demand for oil and natural gas. As OPEC continues to gain market share by producing at a cheaper cost, the US will continue to see a decrease in rig count. For SLB this means they will continue to endure lower sales revenue as a portion of their customers cut production. The first quarter earnings act as condemning evidence that the current market environment has impacted the company. SLB experienced a drop of 13% in North American sales when compared to the same period last year. North American operating income also dropped by 39%, even after the company reduced its workforce at the start of the year. The lower earnings prompted the company to further reduce its employee head count. Additionally, as of Q1 2015, the company also lowered their capex to \$2.5 billion, down from \$3.0 billion at the start of the year and \$4 billion in 2014.

With cost constraints facing the industry, where are the opportunities for SLB to make a profit? In manufacturing during a price downturn, emphasis is placed on improved efficiencies, typically gained from cost cutting. As mentioned, since the end of 2014, the oil industry, both in the US and internationally, has seen a contraction in spending with reduced rig counts, decreased labor force and capital investment expense. Undoubtedly, North American producers and others around the world will continue to produce oil and gas; however, they will turn to their most economical fields for production.

¹ (Schlumberger, 2009 & 2014)

² (Richter, 2015)

³ (Baker Hughes, 2015)

⁴ (Sunne, 2014)

For SLB this translates into overall less sales revenue as the industry directs its focus to proven, more economic wells. Lower oil prices create less incentive for producers to fund new exploration projects, resulting in fewer drilling opportunities, and a lower number of producing wells; these are the three segments SLB operates in. In the recent Q1 2015 earnings release SLB forecasted a 30% reduction in spending from its North American upstream customers and a 15% decrease internationally. Case in point, Saudi Arabia, the world's largest player in the industry and an SLB customer, is looking to cut their service provider costs by 20%⁵.

Consideration should also be given to industry regulation. Deregulations in 2004 and 2005 helped accelerate the US fracking boom, whereby the industry was exempt from several laws designed to protect the environment. However, those exclusions may now be in jeopardy⁶. Recently, the Obama administration revealed new fracking rules that will increase inspections of drilling rigs and wells. Additionally, there is an increase in transparency, requiring companies drilling on public lands to disclose the chemicals used in the fracking process⁷. While the industry quickly responded with a lawsuit to curb the new regulations, the threat to SLB products and techniques is still real. While drilling on public lands only accounts for a small portion of US drilling wells, there is a strong belief that state and local governments will adopt the new rules as well. The idea that other regulators will embrace the rules is even more tangible as news reports highlight the correlation between earthquakes and fracking⁸.

To the credit of SLB and its position strategy, it has the opportunity to make the best of the situation with its proven business segments. The three segments allow the company to navigate through pricing trends. Presently, with the depressed commodity prices, SLB has committed its attention on production efficiencies to support its customer base. The company has also indicated that they are fostering a closer relationship with their customers to help traverse the current environment, leveraging their relationships in the industry to ensure their going concern. Customer collaboration will allow SLB to help manage their client's time and costs, giving them the opportunity to closely monitor their sources of upstream income. The commitment by SLB to collaborate with its stakeholders may prove to be its next strategic advantage, creating a customer relationship platform as substantive as its product lines.

2. Company Analysis

SLB has three segments focused in the oil and gas industry, referred to by the company as, their reservoir characterization group, drilling group, and production group. The reservoir characterization group is focused on the exploration of oil and gas, as well as, providing data on existing wells. The reservoir characterization segment delivers imaging for wells and reservoirs, and also offers industry leading proprietary software solutions. Additionally, the segment provides training for their clients, specific to the well or exploration project. The drilling group harnesses the company's proprietary technologies as they relate to drilling. This is in the form of specialized drill bits, well construction and engineering, and environmental services and training. The last segment is the production group, which focuses on maintaining the well once it is in production. The segment offers servicing, artificial lift or pumps within

⁵ (Said, 2015)

⁶ (The New York Times, 2011)

⁷ (Davenport, 2015)

⁸ (Bojorquez, 2015)

the well, data on the wells production, and water services. The alignment of these services allows SLB to capture the oil and gas production life cycle; with finding, drilling, and producing the commodities. The breadth of services and products gives the company the strength to shift their efforts depending on the industry environment. Currently, with low prices for the minerals and cost compressions within the industry, SLB can focus its attention on production efficiencies, while it is expected that the drilling and reservoir characterization segments will be in less demand⁹.

Another notable strength for SLB is the global market they operate within. The company has relationships with large production companies, both state and privately held. As one client fights to control costs another client is striving to increase production. With such an array of customers SLB has real time intimate knowledge of the industry, across geographies, which should allow them to quickly adapt to the market as it unfolds before them. Additionally, with sales in multiple geographies, SLB is not heavily reliant on North American production, which accounted for only a third of the company's sales in 2014.

A weakness for SLB is the company's sole concentration on the upstream segment of the oil and gas industry. The portfolio of products SLB offers is centered on the commodities and is therefore influenced by commodity price volatility. The lack of industry diversification prevents SLB from benefiting from the low price environment. If SLB had enterprises that were benefiting from cheaper energy prices, such as refining, then perhaps it would not have need to have two rounds of layoffs and substantial cuts to its capital expense in 2015. The cost cutting undertaken by SLB may also prove to be a weakness, as regulations and cost cutting measures may require additional product development and research.

An opportunity exists for SLB as US fracking industry hibernates to weather the downturn. Saudi Arabia is reported to have the world's fifth largest shale reserves and has allocated \$7 billion to the development of their own fracking production boom¹⁰. SLB can leverage its global relationships against the experience gained from the US fracking boom, this could be a great opportunity for company to replace its vanishing sales as the US fracking market recoils from the recent price hits.

Another opportunity for SLB lies in its ability to capitalize on inorganic growth opportunities that the current economic environment may present. Historically, SLB has completed several mergers and acquisitions. Traditionally, the company has a successful track record of acquiring smaller companies to gain access to products and process. However, in 2010 the company did acquire Smith International for \$11 billion, proving they aren't opposed to bigger targets.

A threat that SLB should consider is the recent merger by Halliburton and Baker Hughes. Although, currently SLB sites this as an opportunity to gain market share as the two companies focus their efforts on consolidating. Eventually the two companies will complete their transaction and SLB will have a larger unified competitor vying for market share. It is plausible that once the new company is established the envisioned synergies that prompted the union may become tangible, allowing the company to regain lost market share.

Another threat to SLB is the strength of the dollar, the company's functional currency. If the company is receiving price pressures from its clients and there are additional pressures from the strength of the dollar,

⁹ (SLB, 10-K, 2014)

¹⁰ (Bird, 2015)

how much will SLB be forced to cut its price? A further point to consider is if SLB is forced to cut prices in one market will those new prices transfer to another geography, pressuring the company to lower prices for other clients.

3. Industry Analysis

The oil and gas industry is a mature industry with high competition, tight margins, and abundant regulations. The penetration of the commodities to markets around the world is attributed to their usefulness as an economic energy input. Furthermore, with technology advancements, nearly every ounce of oil is consumed as a different good, such as various fuels, lubricants, and petrochemicals or plastics.

Broadly viewed the industry is divided into two strategies, called conventional or unconventional plays. Conventional plays refer to the traditional form of extraction where a well is drilled and a rig pumps the oil out of reserves in the ground. The conventional play has traditionally been cheaper for oil extraction as a producer needs only to find the reserve, create and monitor the well, and if pressure in the well declines add pumps to increase production. On the other hand, unconventional plays refer to other more costly methods or techniques for getting at more difficult oil and gas, such as in shale or oil sands. The unconventional play has gained more attraction as oil prices have increased allowing for more expensive systems like fracking profitable. However, as oil prices have fallen so have investments in unconventional plays.

The industry is separated into three broad sectors, upstream, midstream, and downstream. Each sector is focused on a different portion of the oil and gas value chain. Upstream, commonly referred to as Exploration and Production (E&P), covers the exploration, discovery, and extraction of the commodities. E&P activity can be on land or offshore and for both conventional and unconventional plays. The midstream sector is focused around the transportation and storage of the fluids to include pipelines, railroads, oil tankers, or freight trucks. The last sector of the industry is referred to as the downstream sector and includes refining, marketing, and selling the products.

The high barriers of entry and global demand for the commodities is evident by the major production players in the market, of which, 4 of the top 5 are state run or national institutions. The world's largest producer is the Saudi Arabian Oil Company, with 7.6% market share and is estimated to hold 25% of the world's oil reserves. Exxon Mobil is the world's largest privately held company, with a 2.8% market share and 2014 revenues of \$935 billion¹¹.

Competition within the industry is high and is stratified into two categories; internal and external. Internal competition relates to competitors within the traditional oil and gas industry. Most identifiable is the Organization of the Petroleum Exporting Countries (OPEC) which accounts for 40% of the world's supply and account for 60% of all exports¹². The strong degree of internal competition allows for many merger opportunities, most pointedly is the recent announcement of Royal Dutch Shell to buy BG Group, the third largest energy company in Britain¹³.

¹¹ (Crompton, 2015)

¹² (Crompton, 2015)

¹³ (Zhdannikov, 2015)

External competition is in the form of alternative fuels or products that would threaten industry market share, such as, biofuels or electricity as a fuel. This area of competition is currently considered low for the industry, especially when commodity prices are low. However, as prices for the commodities rise external competitor products will place additional pressures on the industry.

The future outlook for the industry is expected to have less volatility in production and price. However, there is a finite amount of oil and gas that can be extracted; therefore, prices will reflect that dwindling supply as the commodities become more expensive to extract. As prices increase and as economies around the world become more advanced reliance on these traditional forms of energy will subside.

Schlumberger (SLB)	<u>2009A</u>	<u>2010A</u>	<u>2011A</u>	<u>2012A</u>	<u>2013A</u>	<u>2014A</u>	<u>2015F</u>	<u>2016F</u>	<u>2017F</u>
Stock Price	\$ 55.35	\$ 63.69	\$ 82.69	\$ 71.62	\$ 79.87	\$ 98.35	\$ 90.61	\$ 88.94	\$ 90.12
Net Income	\$ 3,134	\$ 4,267	\$ 4,997	\$ 5,490	\$ 6,732	\$ 5,438	\$ 4,898	\$ 4,803	\$ 4,875
Basic EPS	2.59	3.38	3.67	4.1	5.05	4.16	3.8	3.7	3.8
Sales	22,975	28,931	39,540	42,321	46,459	48,871	39,115	38,391	38,904
Shares	1,214	1,263	1,361	1,339	1,333	1,308	1,295	1,295	1,295
sales per share (basic)	\$ 18.93	\$ 22.91	\$ 29.05	\$ 31.61	\$ 34.85	\$ 37.36	\$ 30.20	\$ 29.65	\$ 30.04
P/E	20.7	19.3	21.9	17.4	16.1	23.7	24.0	24.0	23.9
P/S	2.8	2.9	2.8	2.3	2.3	2.6	3.0	3.0	3.0

* Analyst's own calculations. Source of basic data: company's 10-K; Yahoo! Finance

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