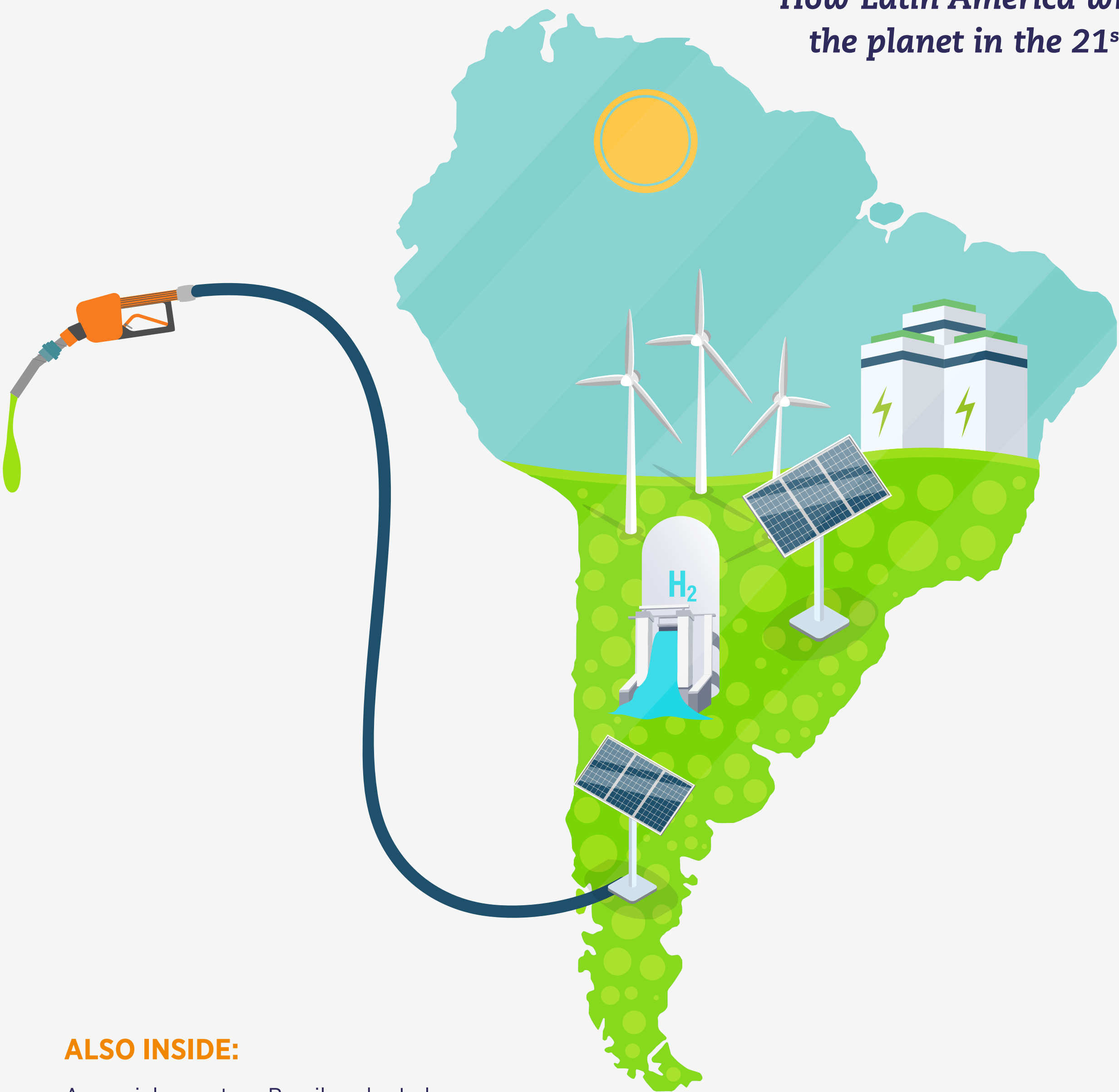
Q4 2022

LatAm INVESTOR

The UK's only Latin America-focused investment magazine

THE WORLD'S CLEAN ENERGY STATION

How Latin America will power the planet in the 21st century



ALSO INSIDE:

A special report on Brazil under Lula

S&P Global analyses the latest financial data from Latin America

Sustainable real estate investment opportunities

We need Latin America's **low-carbon oil and gas**

The region is home to the clean, cost-effective hydrocarbons we need to fuel the energy transition...

It is safe to say that oil is not very popular at the moment. Universities are closing their petroleum faculties because young students believe the industry has no future. Governments across the world have made ambitious plans to stop using it. Even the oil companies themselves seem keen to disown hydrocarbons, with a raft of name changes that remove any reference to the black stuff.

> *At SLB we support the energy transition and we are working a technology portfolio to be a key actor during this change*
>
> **Ruth Zambrano, Managing Director for SLB**

There is a widespread assumption that the world is on an irrevocable energy transition that will move us out of the oil age. This assumption is correct but there is one problem – few people realise how long it will take. Yes, we desperately need to reduce emissions of greenhouse gasses (GHGs). But that requires a gigantic, multi-decade investment programme to electrify the global economy. To build that new, all-electric infrastructure we need to use the best tools at our disposal – and at present oil and gas are, by far, the most powerful, flexible and cost-efficient fuels we have. The quickest way we can cut GHG emissions, while building our green, new world, is to use the cleanest oil and gas available.

"I think the transition will take several decades", says Martin Grisolle, General Manager, Hunt Oil Peru. "I know we hear a lot about different countries or companies that pledge to be carbon neutral but I don't see how the whole world can do it quickly.

"Take China, for example, at present 62% of power generation comes from coal, with approximately 20% more coming from other fossil fuels. The amount of investment needed to replace that 80% of thermal power generation with renewable energy is impossible to deploy in a short time frame. So, it will be a long time before China is carbon neutral. Maybe there are a few European companies or countries that can become zero emission more quickly, but most of the world will need several decades. And during that timeframe, switching to natural gas is the most effective way at reducing emissions."

Hunt Oil Peru is one of the country's largest gas producers, part of a consortium working the immense Camisea gas project. So it is understandable that Grisolle is a big proponent of the fuel. "I believe that natural gas is the fossil fuel that helps humanity transition away from fossil fuels", says Grisolle. "I know that sounds strange but natural gas is the cleanest of all the fossil fuels and by switching from coal or oil to natural gas we can make massive emissions reductions. I don't see any way that we can move overnight from a world that today still runs mainly on fossil fuels to one that is zero emissions." But while gas has its advantages, oil remains the world's most important energy source. Indeed, it has other uses too, explains Ruth Zambrano, Managing Director for SLB – a global technology company focused on the energy transition - in Peru, Ecuador and Colombia.

"I think there is a lack of understanding around the whole world about the importance of oil", says Zambrano. "People don't realise that everything, from the paint on the wall to the plastic on their phone, needs oil. Everything we consume uses oil at some part of the value chain.

"I believe that the recent geopolitical conflict has highlighted the importance of energy security. Everybody was talking about the energy transition and then we suddenly realised that we still need oil and gas. We have seen European countries turn back to coal-fired power plants, despite the extra CO2 that emits, because energy security is as important as the transition. When things get difficult the human being will do whatever it takes for two things: to heat and to eat. At SLB we support the energy transition and we are working a technology portfolio to be a key actor during this change but we also realise that it will take decades because many of these technologies are still in full deployment stage." In his recent book, The New Map, energy analyst, Daniel Yergin, posits a 'planning scenario' in which the current consumption of 100 million barrels of oil per day, rises to 113 million barrels by 2050. One reason is that cars and light duty vehicles only account for 33% of oil demand, so even if we manage to replace the entire global fleet to EVs we will still need more oil for petrochemicals, aviation fuel, asphalt etc for a rising population.

Clean oil

Once you face the reality that the world will still be producing billions of barrels of oil per day in 2050 then the next step is to make that fuel as low-carbon as possible. And that's where Latin America comes in. Home to 20% of the world's oil and gas reserves, but less than 10% of its people and GDP, the region is a natural exporter. It also contains some of the 'cleanest oil' in the world. This concept isn't widely understood by the general public but as ESG principles become more important for institutional investors, they are allocating their capital to energy companies that mitigate their environmental impact and have a positive social influence.

Alfredo Mordezki, Head of Fixed Income, Latin America, for Santander Asset Management, manages several funds for his clients. One of them is an ESG fund, which we discuss elsewhere, but it is striking how environmental and social concerns are now an important part of his general funds. Here he runs us through how each aspect of ESG impacts his investment decisions.

"Governance has always been relevant for credit risk because it is an integral part of the willingness of a debtor to return the money it has been lent", says Mordezki. "Nowadays the E and S are much more relevant for credit risk because there are more disclosure requirements and questions from investors and ratings agencies. Take an energy company as an example - it will be routinely asked about how it is going to manage the energy transition, their emissions strategy and targets, the re-

Why Latin American oil and gas needs private capital

Traditionally Latin American oil and gas production has been dominated by its national oil companies. Mexico started the trend when Lazaro Cardenas nationalised production in 1936 and created Pemex, the country's national oil company. Since then national oil companies have sprung up in all of the region's major oil and gas producers: Brazil has Petrobras, Argentina has YPF, Bolivia has YPFB, Venezuela has PDVSA, Colombia has Ecopetrol and Ecuador has Petroecuador. The record of these companies is mixed. Ecopetrol and Petrobas, which are both listed on the NYSE, are the most successful and have succeeded in boosting national production. Ecopetrol is also a leader in clean oil and was one of the first to stop flaring gas in Latin America. YPF has a mixed record but deserves credit for overseeing the development of Argentina's massive Vaca Muerta deposit.

On the other end of the scale PetroEcuador doesn't seem to be making the most out of its country's resources, while politically-managed PDVSA has become a slush fund for the country's kleptocratic elite, sending national production to 300,000 bpd from 3.5million bpd in 1998. In Mexico Pemex has notable successes in the past but currently lacks the financial muscle to develop the country's impressive offshore deposits and the country's oil production has fallen to 1.9 million bpd, down from 3.6 million bpd a decade ago.

The result is that investors have plenty of choices, says Mordezki. "In Latin America you have the 'Noics' – National integrated oil companies. They have some state ownership and have businesses through upstream to downstream. Then we have the independent small companies that only focus on exploration and production.

The advantage of not being exposed to refining, is that you avoid the sensitive issue of (retail) fuel prices. But for these smaller producers, the E&P business is a grow or die story. The fixed costs need to be diluted by expanding production. They are all aiming to get above 50,000 bpd to leave the danger zone where fixed costs can destroy you if prices fall."

»

The solution is to have thriving oil and gas companies like GeoPark that can produce low-cost energy and invest excess returns in positive social and environmental impacts

Andrés Ocampo,
CEO, GeoPark

lationship with communities, etc.

"If you look at Latin America, we have had energy companies that disregarded environmental and social impacts, while there are others that have had excellent standards. In our Article 6 Latam Credit fund, we do invest in some oil & gas companies but ESG metrics do have a say on our investment decisions. For example, we will assess the C02 emissions per barrel produced.

You may find that Latin American companies listed in Canadian, US or European exchanges will disclose more of ESG information than pure local peers, because they are required to, but this provides a benchmark to the locals.

"There are quite a few different ways to get exposure to the energy transition in Latin America. One obvious way is through the energy generation companies. However, investment approach can differ. Some money managers just take a snapshot of the company metrics in the present moment. If it has some fossil fuels in its energy mix then they may decide not to invest in it.

However, we need to consider the direction the company is travelling. If a generator has some legacy fossil-fuel assets but it is investing in cleaner fuels and is aligned with the host country's climate goals, then I think that is a positive step for the transition."

The nuanced, considered approach from Mordezki contrasts with the hysterical tone of the climate debate playing out in our newspapers and TV screens. The reality is that we have to work with the world as it is, not as we want it to be. And switching off all the world's oil and gas wells overnight would not create the 100% green energy matrix the planet needs.

Financing clean oil

As Mordezki says, the most established measure of oil's impact is the C02 emitted in the process of making each barrel. On that criteria South America scores very well. Each barrel of oil produced in Argentina's Vaca Muerta shale basin, emits 15.8 kg of C02 per barrel, well below the global average. Indeed GeoPark, an NYSE-listed, independent Latin America-focused oil and gas E&P that produces oil onshore in Colombia, Ecuador and Chile, emits 19.6 kg of C02 per barrel. To give some comparisons with other major oil producers, the US emits 19.9 kg of C02 per barrel, Russia 20.7 kg, Canada 36.6 kg and Mexico 42.3 kg. So if the world still needs oil but wants to reduce emissions the solution is simple – replace the dirty oil with cleaner onshore Latin American crude.

"The energy transition can't happen without reliable, clean oil and gas, so it doesn't make sense to starve the industry of capital", says Andrés Ocampo, CEO, GeoPark. "Indeed, high oil prices hit renewable energy because they make it less competitive as an investment. The solution is to have thriving oil and gas companies like GeoPark that can produce low-cost energy and invest excess returns in positive social and environmental impacts. Embedded in our five-year plan is a commitment to reduce carbon emissions by 40% over the next three years. Hopefully we can do even better."

If the world wants to cut emissions during the transition it needs companies like GeoPark to increase production. "We definitely want to get our production to 100,000 boepd", says Ocampo, using the measure of barrels of oil equivalent that also includes gas production. "However, we are realistic about what that means. Being a larger company multiplies both the opportunities and the challenges – after all, when you are producing that much you need to replace 40 million barrels of reserves per year. But that size makes us a meaningful, a less risky investment for institutional investors."

"If we implement our five-year plan, we can grow organically to between 55,000 boepd and 60,000 boepd over the next five years. That growth will be delivered by developing our own assets and unlocking our high-potential portfolio. We are drilling around 50-55 gross wells this year, 35-40 of which are development wells and 15 are exploration wells in core areas. It is the most ambitious exploration campaign in the history of the company as we are drilling back-to-back, low-risk, high-potential wells. We can keep up that pace of drilling for the next five years."

"Growing at 10% CAGR is good", says Ocampo, "but we believe we may be able to grow even more. Our average chance of exploration success is approximately 15% to 45%. If our results are better, then our annual growth will exceed 10%."

That type of steady 'growth by the drill bit' is what has made GeoPark an investor favourite but acquisitions can accelerate that. "We are selective and patient buyers and will look for the right opportunities either in Colombia or elsewhere. In 2019, we completed two types of acquisitions that gave us 1.5 million extra acres in the Llanos basin. Two-thirds came from bidding rounds, which didn't require any capital upfront. The rest was through the acquisition of Amerisur. We were unable to raise equity because the target company lacked timely financial statements, so we financed 100% with debt, which isn't what we normally do." Since the acquisition GeoPark has been steadily reducing that debt, repaying $275million in the last 18 months while also paying dividends and buying back shares.

"Looking ahead the third option is to use our own equity", says Ocampo. "Maybe today it doesn't make sense because we are not fully priced, so it would be expensive and dilutive but with the right opportunity that creates value for shareholders we can use equity, which is our own currency. We have been listed on the NYSE since 2014 and never raised equity, which shows that we are disciplined in our use of equity. That is good for shareholders because you preserve their stake, but if you are in the biggest capital market in the world you should probably ask for capital, or use it, at some point." In theory the new era of high interest rates should complicate M&A activity but Ocampo doesn't believe it will stop GeoPark, which also partners with Petrobras in the offshore Manati gas field, to increase. "If we are financing with debt and the interest rates are higher, then we need to ask for larger returns - way beyond the 5%, 10% capital cost or debt cost we are seeing in the markets. Oil prices impact more than interest rates. A high oil price makes it harder to find good acquisition opportunities."

The world needs oil and gas to fuel an energy transition that will take decades to complete. In the meantime, we need to reduce emissions by allocating capital to the low-carbon oil and gas producers. Well-run Latin American energy companies should benefit from the inflow of capital while helping the planet. ■