



What does it mean for the stocks?

For the equities, the debate centers on the pace of the recovery in crude price, and how soon should investors pay for it. Given what we view as a rather tepid recovery in crude over the next 18-24 months, (followed by significant long-term strength), and relatively aggressive current implied valuations (sector discounting \$75/bbl+), we remain focused on names that have the asset quality and balance sheet to grow production in a capital efficient manner (ie. largely within cash flow) in a moderate oil price world. **We upgrade OXY to Buy and downgrade HES to Hold** on an improving outlook at OXY (Permian exceeding expectation + FCF generation and cash return to shareholders at the current strip). Other preferred names include: DVN, MRO, EOG.

- OXY: We upgrade OXY to Buy (from Hold) on its advantaged combination of growth and free cash flow in a moderate oil price environment. We see a number of key drivers for OXY, including: 1) Permian performance continues to exceed expectations, with likely upside to conservative 2016 target of 120 Mboe/d, 2) leading FCF generation in our coverage universe at \$65/bbl WTI (1.8% post-dividend in 2016, or 5.8% pre-dividend, vs. peer average of a 2.4% FCF deficit in 2016), led by three primary Middle East projects which generate ~\$1.0-\$1.5 Bn/yr of FCF, 3) 2017 start-up of ethylene cracker driving ~\$1.0 Bn/yr of FCF from the chemical business from 2017, 4) 2nd highest dividend yield in our coverage universe (3.9%), with FCF driving further growth and share buyback, 5) solid crude leverage in the case of a rebound in oil price, and 6) relatively attractive valuation at 6.7x 2017 EV/DACF (or 6.4x adjusted for Midstream/Chemicals segments).
- HES: We downgrade HES to Hold (from Buy) primarily on account of the company's notable outspend (second to worst in the group based on 4Q15 annualized figures). We expect investors to continue to struggle (4%/3% underperformer since recent WTI trough/in May) with HES' relatively high spend on investments that are not expected to generate near-term cash flow (North Malay Basin, US midstream, Stampede, exploration, etc); not surprisingly, HES scores last on our defensive scorecard despite offering a healthy balance sheet (4th in the group on a '16 net debt/cap basis). While an attractive valuation (5.6x 2017 EV/DACF vs group at 6.4x) and impressive liquids leverage (highest in the group) sets up well for investors looking to play a crude price bounce, our defensive-tilted outlook suggests HES's medium-term outspend/ FCF profile will remain in the spotlight.

Primary Risks: global demand, supply delays, decline rate and OPEC

We view the following as amongst the primary risks to our outlook:

OPEC – Outside of a change in policy by Saudi, we see two primary risks to our forecast in the immediate horizon (6-12 months): Iran (a potential reduction in the call on US growth by ~450 Mb/d) and Iraq (increased export volumes out of Kurdistan an incremental ~400 Mb/d over 2014 levels presently) Longer-term growth in sustainable productive capacity from Iraq and the UAE pose the greatest risks to an increased need for US onshore crude during the tail-end of our forecast period. As for Saudi, we sensitize our outlook to Saudi market share as a % share of global oil supply. Using a 5 year average market share of global supply, implied go-forward Saudi production results in a call on US onshore growth of ~500 Mb/d through 2018 and increasing to 700 Mb/d by 2019. Assuming current Saudi market share levels (~15%) effectively renders the call on US onshore growth non-existent during our forecast period.