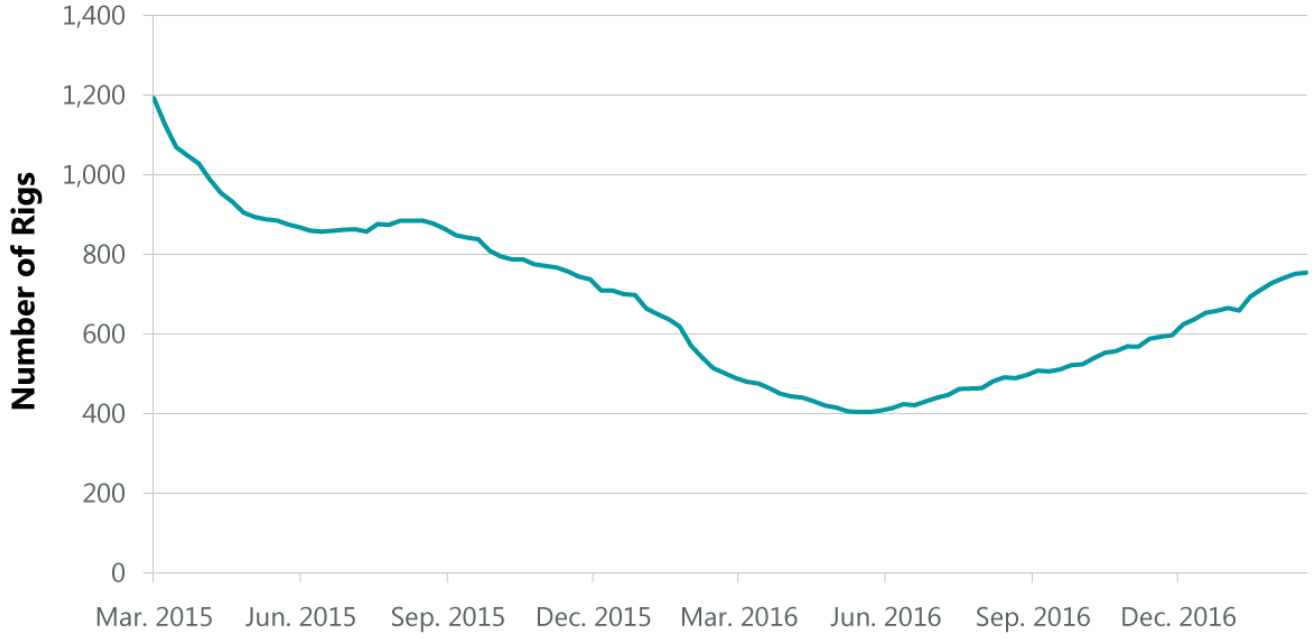
ClearBridge Investments

Oil Services Stocks Regaining Pricing Power

March 1, 2017

The stabilization of crude oil prices above $50 per barrel (bbl) for West Texas Intermediate, increasing capital spending by exploration & production (E&P) companies and rising rig counts have meaningfully improved the pricing and profit outlook for the oilfield services industry. Oil service companies that provide drilling equipment, completions technology, specialized labor and other services should be direct beneficiaries of a more than 85% increase in U.S. rig counts from their 2016 trough (Exhibit 1). Oilfield service companies have endured negative profit margins through the downturn as they subsidized E&P customers' returns with price concessions (Exhibit 2). However, as activity increases, service margins should begin to normalize as these companies claim their fair share of the economic rent of oil and gas production.

Exhibit 1: U.S. Oil Rig Count

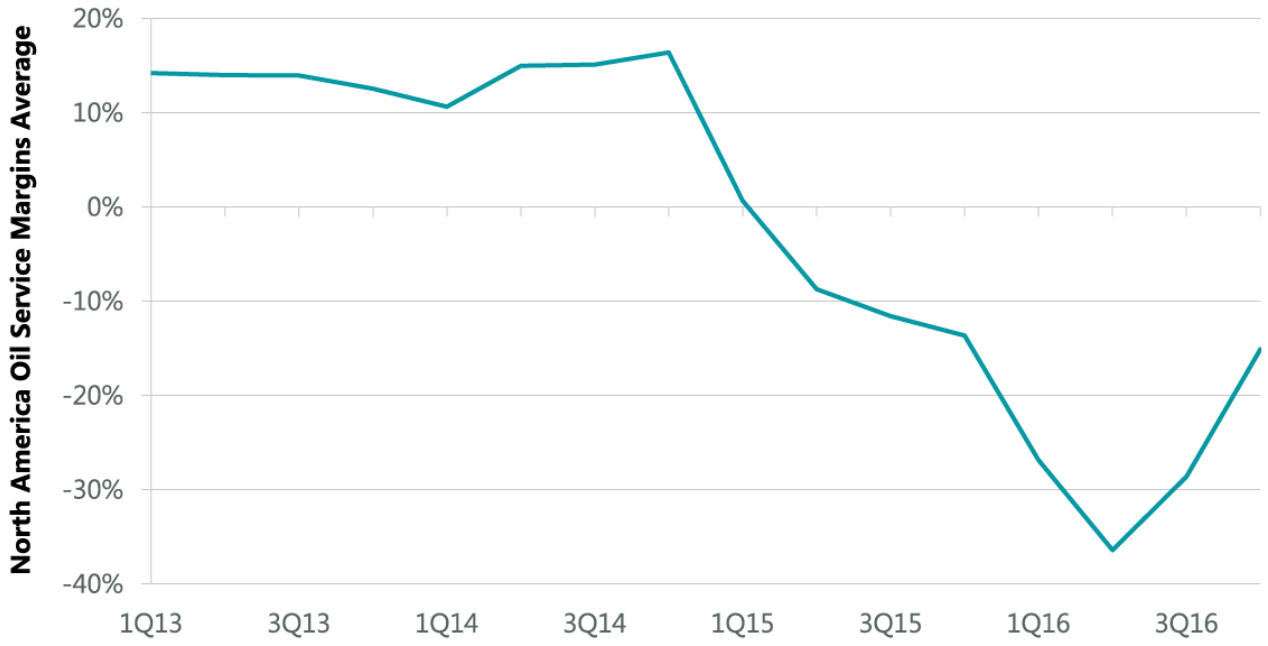


Source: Baker Hughes

The prolific Permian basin is driving much of the increase in activity, benefiting companies with exposure to the region. Available assets are close to sold out and E&Ps are asking service providers to unstack idle equipment which is causing upward pressure on pricing of services. Pricing for pressure pumping is up as much as 30% from recent lows while prices for land rigs, drilling fluids and most other services are also rising. Down the supply chain, the service companies themselves are seeing inflation in sand, trucking and labor. There is a lag before service

providers can pass on this inflation to their customers. As a result, we expect incremental results for oil service stocks in the first half of 2017 to be weaker than in the second half.

Exhibit 2: North America Oil Service Margins Average



Source: RES Technical Services, Halliburton North America, Patterson-UTI Pressure Pumping, Weatherford North America

U.S.-focused service companies should benefit first as shorter-cycle U.S. activity leads the rebound, as we are seeing, while longer-cycle international activity is likely to lag. However, we do think that over time, international E&P spending will rise as well.

We would note that for these trends to continue, oil prices will need to rise beyond the $50-$55/bbl levels. At current oil prices, E&P cash flow will struggle to support continued increases in the rig count much above today's level, which means that we could see a period of digestion in the industry after the recent spike in activity.

About the Author

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- 12 years of investment industry experience
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