Is Putin's war in Ukraine destroying Russia's economic future?

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Whether you call it a special military operation, a preemptive strike, an armed incursion or an outright war, the impact of Putin's actions in Ukraine are likely to have long-term, far reaching impacts on economies around the world, but none more so than that of Ukraine and Russia. I personally believe that Mr. Putin may have underestimated the fierce determination of the Ukrainian people and their military, as well as, the resolve of the majority of the Western world to send a message that what he has done is unacceptable. Looking beyond the short term ramifications of various sanctions and export bans (which we'll briefly discuss later), the long term impact of his actions could result in a sizeable hole that could take years, if the country can ever dig itself out of.

The primary focus for my thesis today is the importance, if not complete reliance of the Russian economy on fossil fuels. According to this BBC article, oil and gas provided 39% of the Russian federal budget revenue and made up 60% of Russian exports in 2019. This Reuters article suggests that by 2020 oil & gas accounted for over 23% of Russian GDP. It also states that overseas trade made up 46% of Russia's GDP according to the World Bank. Oil and gas provided more than half its exports, with metals accounting for 11%, chemicals about 8% and food products 7%. Despite Russia being one of the largest global suppliers of wheat, fertilizer and a few other commodities, it's oil and gas that grease the economic wheels and ultimately finance Mr. Putin's war machine. Yet it seems Mr. Putin is willing to sacrifice his golden goose in pursuit of something that I’m not sure anyone in the world fully understands.

What do I mean by this? The theory is twofold. For starters, between Western sanctions being imposed on Russian energy and the denied but obvious “weaponization” of natural gas, Europe is rapidly advancing its move to alternative energy sources and ultimately renewable energy. Thus if/when this all settles down and things head back to pre-war type of activity, Russia’s fossil fuels could be worth a lot less due to a combination of demand destruction and more reliable suppliers. In particular, only 13% of the world’s natural gas is moved by tankers and the rest by pipelines. Russia has spent a lot of time and money developing the infrastructure to deliver gas to Europe that can’t readily be replaced to deliver comparable volumes to China, India or whoever is willing to do business with them. And without a lot of foreign investment and LNG expertise, it could be difficult for Russia to access global natural gas markets anywhere.

Following on from the European move away from fossil fuels to renewable energy (of note, I’m talking years not months). As global demand for fossil fuels begins to roll over, I’m pretty sure Middle East oil producers will be the last ones standing and Russia will still “lose” both market share and netback pricing. If Russia is relying on China to buy all their commodities they are likely in for a rude awakening because China tends to look out for #1 and is more than happy to put the screws to anyone who is in a weak bargaining position. My understanding is that today both China and India are already paying significant discounts to WTI or Brent prices for Russian crude, a lot more than the typical quality discount (similar to the heavy oil differential we see for a lot of Canadian crude). That will likely only get more punitive if the world moves to an oil supply surplus and customers have more choice over what regime they are willing to support.

As for what’s going on today, we see things like export bans impacting car and airplane parts. Russian car production, which accounts for over 600,000 Russian workers, is down over 90% in the last 6 months. It has led to Russia easing safety measures to allow cars be built and sold without airbags and anti-lock brakes amongst other measures. Russia’s commercial aircraft fleet is comprised of around 55%-60% of foreign built aircraft (primarily Boeing and Airbus) which are no longer providing parts or maintenance services meaning at some point there will probably be a dramatic drop in air travel capacity. This could have a significant impact on the economy given that over 50% of Russian GDP comes from the service industry which includes hotel and catering services, as well as culture and entertainment. Tough to see the service sector picking up the slack if people find it harder and harder to get from point A to point B.

Looking even further ahead into the future, sanctions and a lack of foreign investment today are likely to make things a lot harder for Russia to be able to develop its own renewable energy industry, albeit they do have most of the raw materials. This puts the country and the economy further in the hole as it relies on the rest of the world for technologies and investment to “catch up”, assuming renewable technologies achieve their goal of not just being better for the environment, but a far more economic source of energy.

I don’t have a crystal ball and I have no idea how this whole situation plays out. However, I find it hard to imagine a scenario where in 5 years from now Russia’s economy is in better shape than it was prior to February 24. And the Russian people have one person to “thank” for that.

Experience, low-risk drilling inventory and strategic access helps Southern Energy raise US $31 million

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I always like a story where a hard-working, knowledgeable management team sets its nose to the grindstone to try and eke out a decent return for shareholders, and then almost overnight the world changes and you're one of the hottest stocks out there. Often times it has to do with finding something unexpected with the drill bit that changes the fortunes of the company. However, in this case, it was a commodity price that had languished for years but in the last six months has almost doubled. I'm talking about Henry Hub natural gas prices and if you look back a few weeks it hit a peak of 150% over where it started the year. The Sprott Physical Uranium Trust (TSX: U.UN) wishes it could have that kind of influence on prices. Unfortunately, it was a much larger event that has impacted natural gas prices, along with plenty of other commodities.

Source: StockCharts.com

Even though almost every natural gas leveraged company has seen a great run, the additional bonus for Southern Energy Corp. (TSXV: SOU) is the location of its assets. As a natural gas exploration and production company with its primary focus on acquiring and developing conventional natural gas and light oil resources in the southeast Gulf States of Mississippi, Louisiana, and East Texas, it’s close to most of the U.S. LNG export capacity (even after the Freeport LNG facility, which provides about 20% of US LNG processing, tried to blow itself up). Albeit the Freeport LNG explosion actually caused U.S. gas prices to fall from their lofty heights as a result of 2 bcf/d or a little over 2% of demand for U.S. natural gas having been abruptly eliminated. Nevertheless, as the rest of the world becomes a little less stable, being close to export infrastructure should ultimately be a good thing, in my opinion.

For Southern, its assets in Mississippi are characterized by a stable, low-decline production base, a significant low-risk drilling inventory and strategic access to the best commodity pricing in North America. Southern’s mission is to build a socially responsible and environmentally conscious natural gas and light oil company in the Southeast Gulf States. In these areas, Southern has access to major pipelines, significant Company-owned infrastructure, year-round access to drill, and the ability to shift focus between natural gas or crude oil development as commodity prices fluctuate; all factors that contribute to mitigating corporate risk.

Another factor that will mitigate corporate risk is the recently announced successful completion of a US$31 million equity financing, of which US$12.5 million came from strong demand in the U.K. Another indication that Europe is worried about its natural gas supply and Southern is located in a great place to help support that demand. Net proceeds of the Offering will primarily be used to accelerate the initiation of a continuous organic drilling program at Gwinville, where the Company operates and owns an average 96.7% working interest in approximately 12,000 acres. The Gwinville property represents about 53% of the company’s Proved plus Probable (2P) reserves, and approximately 23% of Southern’s 2021 average production.

At the end of Q1, corporate production stood at 11,515 Mcfe/d of 92% natural gas. Although I would anticipate production to start moving higher as Southern rig released two (2.0 net) wells of the three well program at Gwinville in Q1 2022 with the third well rig released in April 2022. In May 2022, completion operations began on the three-well horizontal padsite. The first well to begin flowback following the stimulation was the GH 19-3 #3 well, which came on-line on May 25, 2022. The GH 19-3 #2 and GH 19-3 #4 wells are expected to be on-line shortly, and the Company is looking forward to providing initial production results in the coming weeks. This may not have a lot of impact on Q2 results but it certainly sets the table for Q3.

The recently completed capital raise by Southern puts the Company on solid footing to start expanding production and take advantage of the best natural gas prices in over a decade. Production assets are ideally located for maximizing corporate netbacks and an experienced and successful management team, with a history of creating shareholder value together, bodes well for the future of Southern Energy. Subsequent to the closing of the latest share issuance (expected July 7th) the Company will have a market cap of roughly C$105 million (based on yesterday’s closing price) and US$31 million to try and make that market cap grow.