Letter from lex: Supply and demand, hope and speculation

Corporate finance occurs across two parallels worlds

Readers,

Writing a finance column allows you to observe two worlds. One is the hard world of supply and demand, where companies struggle to be the best suppliers of whatever it is their customers want at the moment. The other is the ethereal world of speculation and hope, where entrepreneurs and financiers attract money today for satisfying demands that will appear tomorrow.

- A prime example of the first, hard world is what is happening to oil. The price is weak. Companies that deal in the stuff are doing what they can to limit the damage. Oil service companies are, from an investment point of view, a leveraged bet on the relationship between the price of oil and the cost of extracting it. As prices fall and producers (in the US particularly) shut down more expensive production sites, the servicers are in less demand. That Halliburton might want to buy Baker Hughes makes sense in this context: it’s a way for the industry to shrink and become more efficient.

- The oil rig industry, instead of consolidating when times are bad, did it when times were good. This was a mistake. One result was the $2.8bn writedown that Transocean took a week ago. Lex expects more bloodletting in this industry.

When prices fall, explorers may be tempted to put in hedges to protect their profits. Premier Oil has done so, but its share price has plunged all the same. Maybe Premier’s hedging will look wise if prices fall further still. Or maybe investors would rather sell than calculate how effective hedges really are.

Of course, the world of solid fundamentals is not all bad. The fundamentals in the London office property market are excellent. So Lex thinks property companies should make some sales.

- On to the vaporous world of high hopes: Twitter, at its first investor day, made some wild estimates of its “growth opportunities”. The stock popped and Lex was left with its collective jaw hanging open. Alibaba’s network was host to $9bn in transaction in a single day, which is solid enough, but we are left to wonder about where the company’s profit margins are headed. And finally, is there a greater expression of hope and credulity than paying a single man $290m for a year’s work? That is, reportedly, what Bill Gross got as a bonus for 2013. He’s moved to a different company, Janus. An expensive transfer. Now he has to play well for his new team.

Have a good weekend

Robert Armstrong

Head of Lex

Email the Lex team at lex@ft.com

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