January 2020

Energy Stocks: Unloved, Under-Owned & Undervalued

A situation currently exists that shares some similarities to the technology craze of the late 1990s to early 2000 period. During this time, everything but technology, telecom and media companies were labelled “old economy” and shunned by most investors as they chased the growth and promises of the new economy market darlings. Today, energy stocks feel like the “old economy” stocks of 20 years ago, many being left for dead with virtually no investor interest of any significance. In a sign of this dislocation, the market capitalization of iPhone maker Apple Inc. recently surpassed that of the entire listed U.S. energy sector, a sector that is comprised of heavy weights such as ExxonMobil, Chevron, Conoco Philips and Haliburton.

The price of West Texas Intermediate (WTI), the North American benchmark for crude oil, rose by more than 30% in 2019 as reduced supply from various sources mixed favourably with continued increases in global demand. Historically, such strength in the underlying commodity price has almost always been met with a positive response from oil related securities – in fact, correlation figures close to 90% are often cited. This past year has proven to be an exception to this rather reliable connection as most oil-related securities performed poorly, both in an absolute sense and relative to the underlying commodity.

There has been a confluence of issues impacting the beleaguered oil & gas sector. Issues that have been building in strength over the past few years, leaving a dark cloud over the entire sector. One issue has been the price action of oil itself. While the price of oil advanced smartly in 2019, the commodity is well off the post-crisis highs experienced in 2011. In fact, from its 2011 peak, the price of oil lost more than two-thirds of its value over the ensuing five-year period. While the oil price is now some 50% higher than the 2015 lows, stock prices for many oil related companies have never fully recovered (as can be seen in the following chart of the S&P TSX Capped Energy Index).

Source: TMX.

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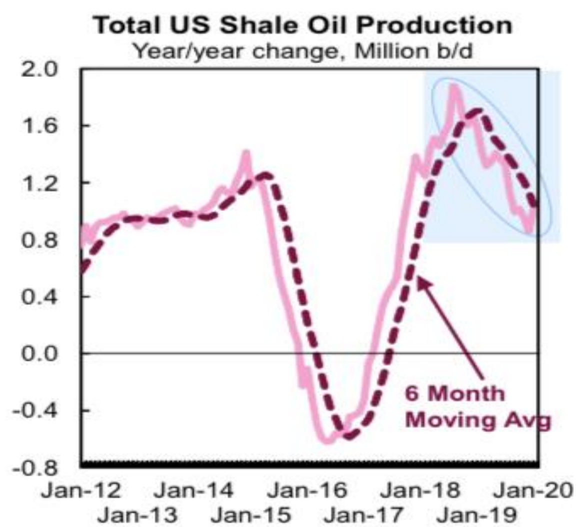
Stock prices within the energy sector have been held back for a variety of reasons. Concerns over seemingly unending streams of supply, projections of long-term declines in consumption, poor capital discipline within the industry and the increasing focus on environmental issues within the investment world have all contributed to the current state of neglect amongst energy-related stocks.

Production of crude oil within the U.S. has more than doubled over the past decade, recently reaching levels close to 12.5 million barrels per day. The rebirth of the U.S. energy industry has been billed as a “renaissance” of sorts, driven by a strong desire to become more energy independent and fueled by improved extraction technology and an abundance of easy money. Outside of the U.S., the past 10 years saw very limited production growth, even with US$75/barrel average prices over the period. Globally, supply pressures were becoming common and the resurgent U.S. was therefore hailed as the panacea to these supply pressures. The thing is, U.S. shale oil (the source of the prolific growth in recent years) was never going to be the long-term cure for global supply, in large part due to the inherently high production decline rates associated with shale’s unique geology. Improved technology and an intensification of drilling techniques has helped extend the timing of eventual declines, but the ultimate recovery won’t increase as production has essentially been front-end loaded. Cracks in the long-term story have begun to appear as financial backing of the growth has become more selective at a time when the geological limits of the oil fields are starting to be met. Recent production figures show a marked deceleration in the production growth rate, which appears to be the prevailing trend.



Source: Cornerstone Analytics.

Another interesting development in the energy investing world is a growing desire by companies to exercise greater financial discipline in their approach to costs and production growth. The energy industry has a reputation for capital destruction led by questionable capital allocation decisions and a focus on growth rather than returns. It wasn’t uncommon to see companies outspend their annual cash flows by levels of up to 150% in efforts to chase growth, with shortfalls often supplied by the ever-willing brokers on Bay Street or Wall Street. Things appear to be changing on this front. Investors have been demanding more financial discipline and companies appear to be listening. There are many examples both in Canada and globally of companies improving their operational focus and structurally lowering their cost base, restraining capital budgets, paying down debt and returning funds to shareholders in increasing amounts – all largely going unnoticed by the investing public.

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Alberta-based Canadian Natural Resources Limited (CNRL) is a good example of an energy company with a history of exercising discipline on many fronts. CNRL, a large holding within most of our portfolios at Sionna, has made tremendous strides over the past decade reducing its cost base and improving its overall efficiency as a leading Canadian producer of oil and natural gas. CNRL has reduced operating costs by approximately 50% in its core Horizon Oil Sands development over the past six years, adding a near C$2 Billion to operating profit in 2019 relative to the 2013 total. Further reductions in future years are targeted. The increased efficiencies have allowed CNRL to produce robust cash flows even during muted oil price environments – cash flows which have led to increasing amounts being sent back to shareholders in the form of dividends and share buybacks. In fact, CNRL has returned a near C$11 Billion to shareholders over the past five years, representing almost 25% of the market capitalization of the business – expect more on this front going forward. However, at recent stock price levels, the market is valuing CNRL at an expected free cash flow yield near 14% – modest levels given the durability of this quality energy company.

Successful investing in oil and gas companies has often required a thoughtful approach regarding management efforts on governance and environmental issues. These issues have recently gained a much higher level of significance amongst the wider investment community here in North America and within Europe. The rise of ESG-focused investing has placed the oil and gas industry under significant scrutiny; and while it is difficult to quantify the full impact of the ESG movement, capital has fled the energy sector as a result. In a blanket-type approach to the issue, many investment organizations have indiscriminately labeled the oil and gas industry 'un-investable'. Unfortunately, the poster child for these concerns and criticism has been our domestic energy sector here in Canada, and more specifically our vast oil sands assets. At times, the perception has been that the Canadian energy industry, with its vast oil sands reserves, produces some of the dirtiest barrels of oil on the planet. The reality; however, offers a far different assessment.

Canada's oil sands operations have made great progress in recent years regarding greenhouse gas (GHG) intensity and overall emissions. Unfortunately, negative views based on historical performance of the Canadian sector remain in place, and with a lack of promotion and education on the progress being made, these lingering myths prevail. Technological improvements and operational efficiencies achieved by oil sands operators since the year 2000 have led to a near 30% reduction in per barrel emissions with further meaningful reductions anticipated over the coming decade. While the quest to further reduce GHG emissions is an ongoing one within the Canadian energy sector, it is important to point out that the GHG emissions emanating from the Canadian oil sands operations equates to a paltry 0.15% of global GHG emissions. The issue really comes down to one of consumption as the GHG emissions created from the end uses of energy (i.e. transportation, electronics etc.) are far greater than the emissions created from the extraction of the fossil fuels themselves – four times greater in fact. This ties into another very important point; our reliance on fossil fuel, the consumption of which isn't going away anytime soon. In fact, by 2040, total energy demand across all sectors of the economy is expected to increase by 20% from 2017 demand levels; and with the third-largest reserves of crude oil on the planet, Canada is well-positioned. Our oil sands assets, which compared to conventional reserves don't suffer from natural declines, are arguably one of the most reliable sources of oil globally. Combine this with the fact that Canada is one of the most stable oil producing nations in the world with recognized leadership in ESG standards and performance, and it is difficult to envision a scenario that includes the demise our Canadian energy sector.

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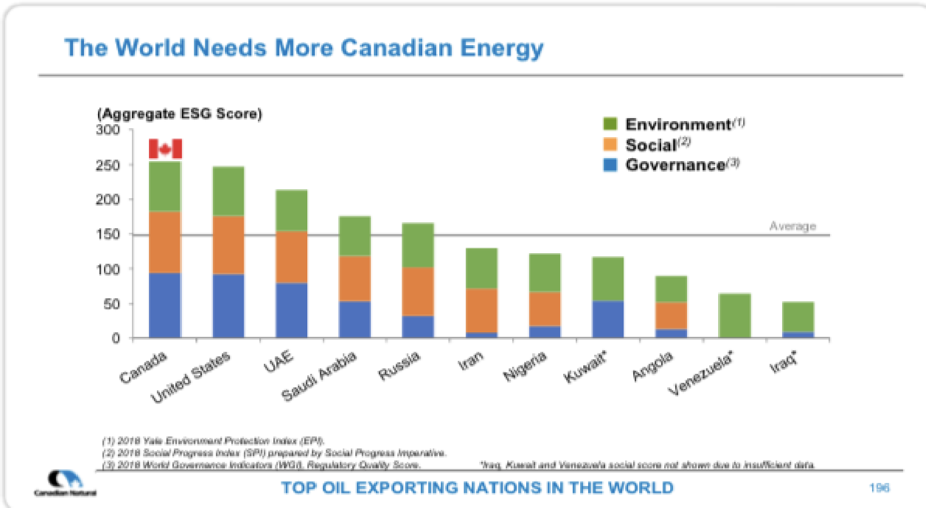

Source: Canadian Natural Resources. December 4, 2019.

Energy stocks, especially in Canada continue to receive little in the way of investor interest. The S&P/TSX Energy Index has lost approximately 60% of its value from the levels of mid-2014 and recently comprised only 16% of the entire Canadian index, down from levels closer to 28% in 2011. The story of neglect is similar south of the border as the energy component within the S&P 500 recently sank to an historical low representation of just over 4%. Valuations, of course, have followed a similar path, with many oil stocks being valued at levels that ascribe little to no economic value to assets in the ground and only modest valuations for near-term production streams.

As value investors, we are naturally drawn to the out of favour, the unloved and under-owned areas of the market. The inherent contrarianism of this approach comes with the territory. Patience is of course also required as even the best-researched investment theses can take an uncomfortable amount of time to play out, but in the end, can often prove to be some of the best investments made.

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