Sionna Investment Managers®

SOUNDBITE

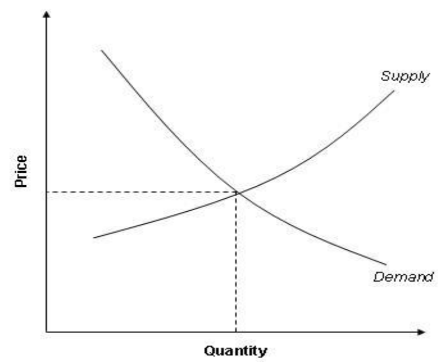
November 2020

Sionna's Value Pick

Kim Shannon's script from the Capitalize for Kids Investors Conference.

Equilibrium is a pervasive phenomenon that exists in all sciences, mathematics, economics, finance and markets. The dictionary definition is "a state in which opposing forces or influences are balanced."

We operate in a dynamic changing business climate. It is constantly adjusting to multiple changes: technological, economic and GDP, politics and regulation, and of course, irrational sentimental interpretations. These changes and influences can become magnified in markets, sectors and securities that may lift to euphoric highs well above core fundamental value, or drop to depressed lows well below fundamental value, as a new equilibrium is slowly found amongst all the influences impacting the financial ecosystem.



This concept is well seen in data series like stock market prices where we witness "reversion of the mean" as equilibrium forces eventually bring valuations back to balance.

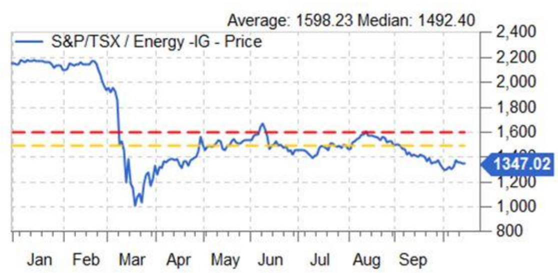
So, as a contrarian value manager, where have the shifts in the financial ecosystem today led to the greatest level of undervaluation below fundamentals?

The energy sector is unloved

The following graphs demonstrate that energy prices weakened with the rest of the market in March but have not recovered as much as the overall market.

The TSX has mostly recovered…

…but the energy sector has not



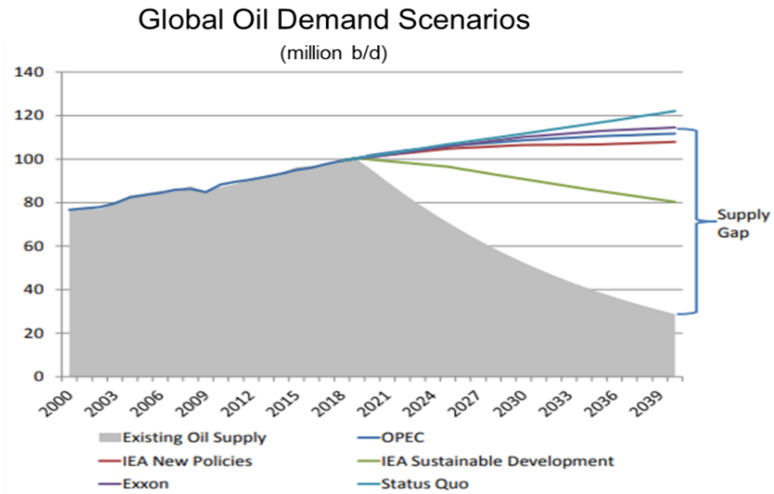
Source: FactSet. October 2020.

It would be hard to exaggerate how brutal 2020 has been for energy, we saw both cyclical and secular forces take WTI from about $60 at the beginning of the year to below $20 in the spring. As a result, energy is at some of its lowest weights in indices, with some energy stocks trading near their lowest valuations in decades.

At the moment, energy is facing two tailwinds. Firstly, cyclical pressures that should subside when global supply and demand is more balanced. Secondly, the long-term secular pressure to transition to lower emissions and renewable energy sources. This pressure is real, but we believe somewhat overblown.

But demand is still expected to grow

Under a variety of demand forecasts, global oil demand is still expected to continue to grow, even as the world seeks to transition to lower carbon sources. New investment will be required, as existing supply is not sufficient.

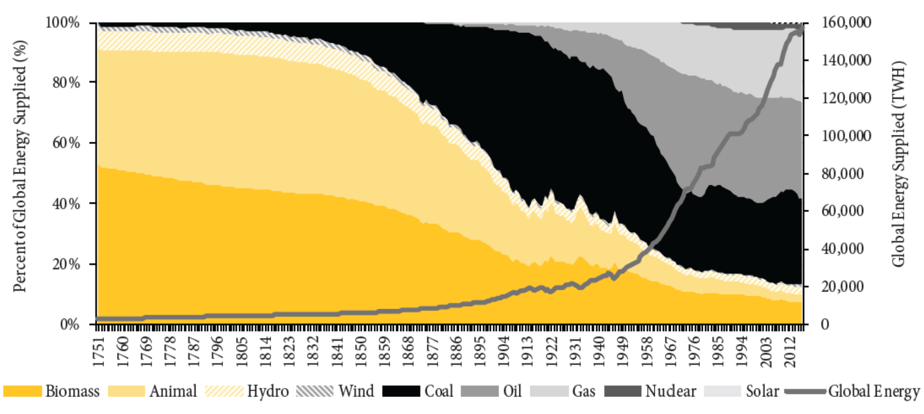


Source: BMO Capital Markets, IEW, OPEC, ExxonMobil.

Meanwhile, a long-term reluctance by both producers and funders has led to a lack of investment in new energy supply streams. This lack of investment coupled with declining reserve bases can lead to a slowdown in production and a new search for equilibrium and balance.

Energy transitions take time…

We like to look at financial history as it provides great insight on how irrational humans have interacted with change in the past. The following chart goes back to 1750 and outlines sources of energy over time.



Source: BP Statistical Review, Carbon Dioxide Information Analysis Centre, Smil V., 'Energy Transitions: Global and National Perspectives, Redburn estimates.

Historically, when a better, less environmentally impactful, more efficient, and lower cost fuel emerged, we gradually shifted to a new equilibrium. Oil at one time was the cheaper and cleaner option. Now, we have some emerging cleaner options, that need more technological breakthroughs to make them more cost effective and capable of eventually being supplied and adapted more widely.

But it takes time. Global coal consumption continued to increase for decades, even as it continued to lose market share to oil and gas and actually had a resurgence when oil prices rose in the 1970s. A major source of emissions is automobiles and there is a belief that widespread use of electric vehicles can resolve that. However, it's a Herculean task to shift electric vehicle sales from the current 2% to complete replacement. Supply chains will need to be redeveloped and human habits will need to be adjusted – this may take decades.

Investors frequently believe transitions will happen much faster than they often do. The Business Week article, "The Paperless Office" of 1975 comes to mind. In the meantime, enthusiasm/pessimism regarding the speed of the transition will impact investment and valuation as the perception of timelines shift. Meanwhile, is there a segment of energy that's been unduly punished?

Where is there a significant disconnect between prices and performance?

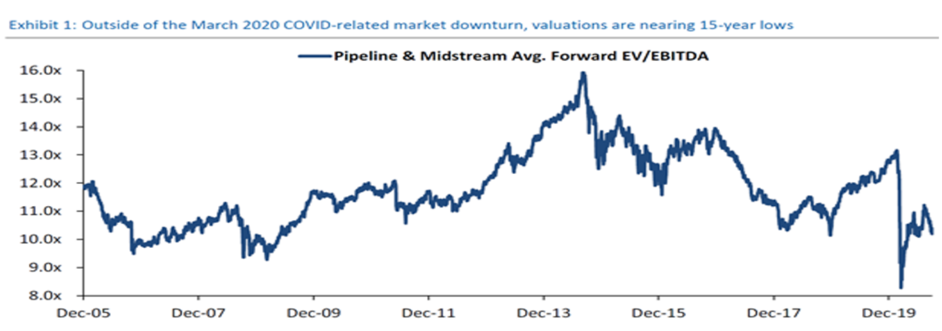
We believe pipeline prices and valuations are priced as if they are more exposed to the commodity price, rather than the actual exposure that can be less than 10% of the business. As a result, today there is a disconnect between fundamentals and stock prices.

Why? Pipelines are embedded in the energy sector in the Global GICs ranking. Thus, some investors tend to lump pipelines with E&P/Integrated/Servicers. However, pipelines have more resilient cash flows and earnings since a high percentage of revenue can be underpinned by contracts and therefore not directly impacted by short-term commodity price swings. Due to their role as necessary infrastructure, providing cost-efficient delivery to customers, pipelines have oligopolistic (and at times monopolistic) characteristics, which additionally enhances their long-term value. Hence, the overlooked opportunity – pipelines currently appear to trade more in-line with a volatile commodity product when most revenues are actually contracted.

The market is even unwilling to pay for forecasted earnings

As the following chart demonstrates, pipeline and midstream companies are trading around 15-year lows. Even for forecasted earnings, investors are currently showing little appetite for future earnings.

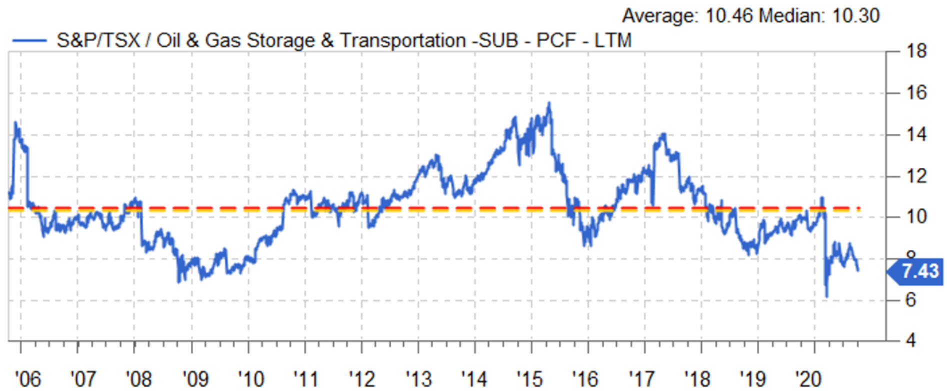
Pipeline and Midstream Average Forward EV/EBITDA



Source: RBC. October 1, 2020.

An overlooked opportunity hidden in plain sight

15-Year Trailing P/CF for TSX Oil and Gas Storage and Transportation



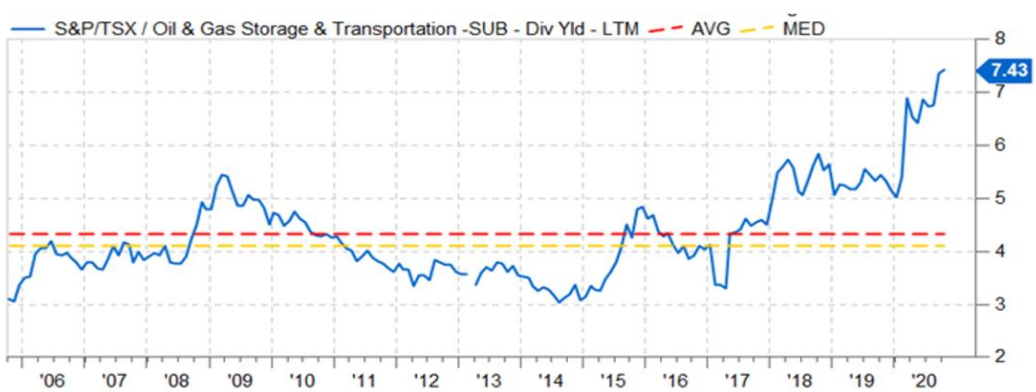
Source: FactSet. October 2020.

As the graph above demonstrates, selected pipelines can offer one of the best opportunities in 15 years – with a potential 40% expected return if the sub-sector's price-to-cash flow reverts back to its long-term average. This metric's decline is similar to the decline in oil prices, despite the fact that certain pipelines have more stable revenue and earnings as mentioned.

Remarkably attractive yields in a stable earning sector

Additionally, as the following graph demonstrates, the pipelines and midstream sector offers a remarkably generous yield – the best since the early 1990s, yet the interest in pipeline stocks in aggregate remains modest.

TSX Oil and Gas Storage and Transportation Dividend Yield

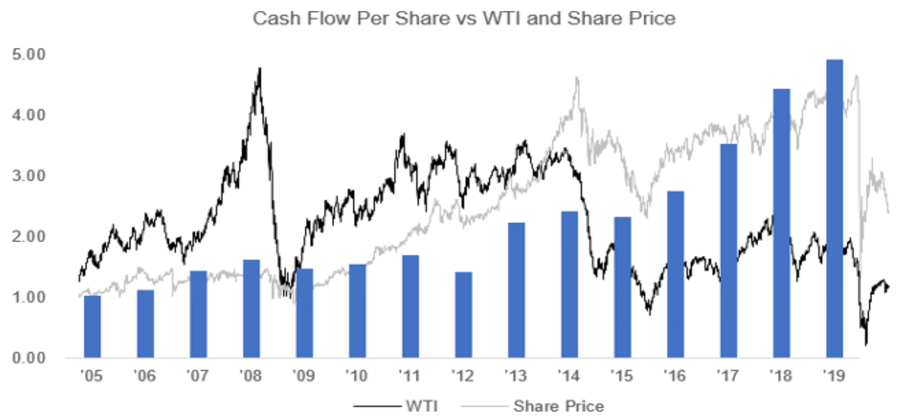


Source: FactSet. October 2020.

These infrastructure assets have utility-like characteristics with resilient cash flows, yet are offering a wide yield spread of virtually 4-8% above the 10-year government bond yield. We argue this is too high and as the market accepts this too, stock prices will rise adding to returns. This combination of valuation and yield suggests to us that this sector is a great place to seek value for a patient investor. And in most cases, we believe the yields are sustainable given the resilient cash flows.

Our value pick: Pembina Pipeline

Our high-conviction value pick is Pembina Pipeline – a midstream pipeline, the third largest in Canada, just after TC Energy (which we also hold in some of our strategies) and Enbridge.



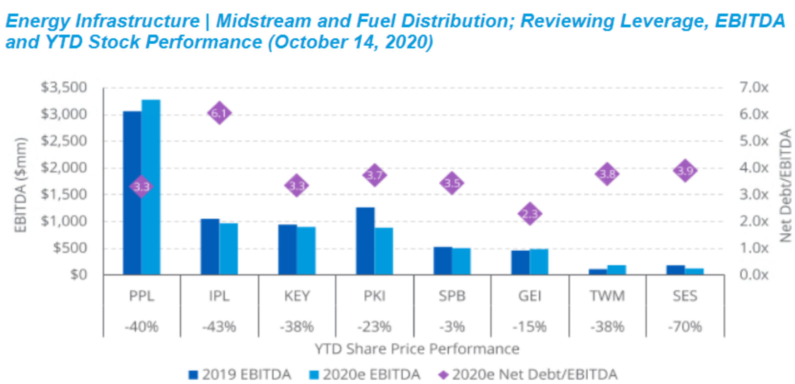
Source: FactSet. September 2020.

The blue bars in the above chart demonstrate how Pembina's cash flow has been more resilient and stable than the stock price or the overall commodity, most notably in the Financial Crisis and 2015/2016 commodity downturns. Additionally, Pembina has a strong risk culture, which contributes to the stability and resiliency of cash flows. This year, management has maintained their guidance range despite the current downturn.

Meanwhile, you can see the soft grey line, Pembina's share price, dramatically and, we argue, irrationally followed the decline in the commodity price, despite only 10% of its business being exposed to commodity price movements.

Pembina has attractive attributes

Midstream pipelines pick up the product from the producers' fields, and then deliver the product to the main pipelines, which are the arteries to major downstream refiners or ports. They provide an essential service and exhibit oligopolistic characteristics.

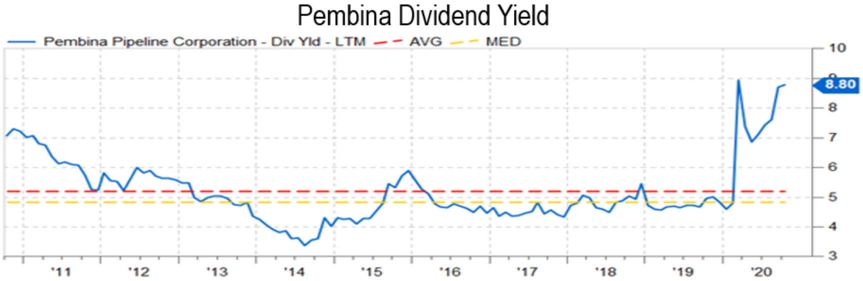


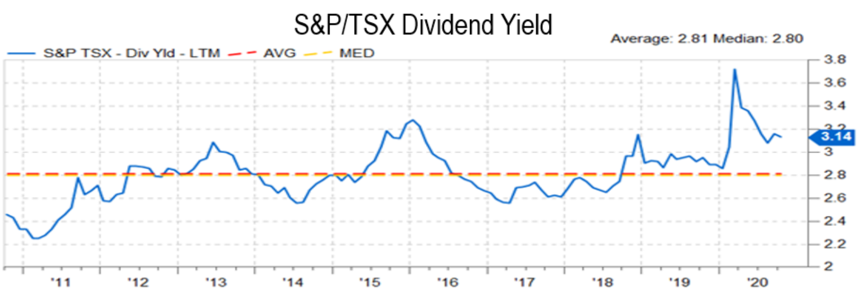
Source: ATB Capital Markets

The previous chart shows how Pembina, the largest of the midstream pipes, fell dramatically despite its previously mentioned steady cash flows and modestly less debt than most comparable companies. Pembina has a management team that leans conservative and prefers cash flow stability over risky investment, and the company has reasonable debt and payout ratios. It also exhibits classic value ratios for entry. Sionna's estimate of Pembina's intrinsic value is $60. The stock peaked earlier this year at just under $54 and closed recently (November 4, 2020) at around $28, so has an expected return of 100%.

Yield is very attractive relative to TSX

As the below charts demonstrate, Pembina has a remarkably attractive 8.8% yield. That yield alone is close to the 1926 historical long-term average total return for the U.S. stock market. Thus, any reversion back to "normalized" yields contributes to capital gains.





Source: FactSet. October 2020.

Additionally, Pembina has a close to 6% spread advantage over the S&P/TSX's generous dividend yield of 3.1% and a 7% advantage over the Global Index yield of just over 2%. So, now the question becomes, how sustainable might this yield be?

Fundamentals suggest dividend is sustainable

We believe Pembina's dividend is sustainable. This stock has grown its dividend almost 5% per annum over the last decade, despite the oil price collapse in 2015/16. The payout ratio has been declining and is 49% of operating cash flow, showing ample capacity to cover this yield. Pembina has a modestly lower debt ratio than its peers, suggesting lower leverage and debt expense, which underscores the quality and risk management of Pembina's management team.

We believe in the next 2-5 years as valuation reverts back to more normalized adjusted levels (down a measure due to emission pressures on the overall sector), this stock could rise from $28 to our estimate of intrinsic value of $60 and earn a total return of 100%.

So, in this type of market environment, the question becomes…

Would you prefer a growth stock? A stock with a limited multiple expansion upwards due to already high valuations and large potential downside risk if sentiment changes, if competition heats up or growth expectations can't keep up with the optimists?

Or would you prefer a misunderstood, solid value stock? A stock that is trading unfairly at historic lows, where a shift in perception of its riskiness should easily deliver a multiple expansion and capital gains. All the while earning close to a virtual normal equity return with an at cost dividend yield of 8.8%?

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With significant input from Portfolio Manager, Gary Chow (covers pipelines).

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