Sionna~
Investment Managers®

INSIGHT

July 2021

Canada's Role in Energy Evolution and Carbon Reduction

This past year has brought some element of change to every business in every sector. As we reflect on 2020 and the many changes that emerged, the Canadian energy industry was arguably one of the most impacted by these changes. Global leaders acknowledged the importance of reducing global emissions with ~137 countries pledging "net zero" goals centered on the 2050 timeframe. This is an ambitious goal to embark upon in normal times, let alone during a pandemic! One cannot underestimate the impact government legislation will have on mandating these changes, hence all businesses need to be nimble, ambitious and innovative; however, today we will focus our attention on the energy sector.

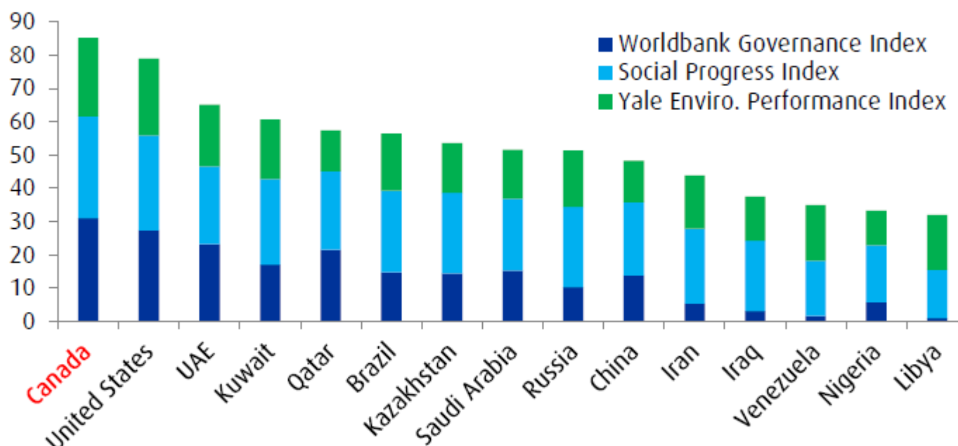
Turning the clock back a year, the energy sector faced many days of reckoning. Many companies did not survive, but the disciplined companies became stronger. Investors, lenders, governments, environmentalists and consumers questioned their practices – and still do today. Energy business models were based upon excess spending of annual cash flows on production growth with capital returns mainly an afterthought – essentially a model leveraged for growth. Times have changed. Today, the mantra is capital discipline based on debt reduction, return of capital to shareholders, free cash flow generation and emission reduction. The new model appears sticky as corporate compensation committees are linking these goals to executive payouts. This topic was originally addressed in an Insight piece written last year by Sionna's Co-CIO, Stephen Jenkins, referencing how the energy industry was undergoing change prior to the pandemic. Environmental, Social and Governance (ESG) concerns, especially with respect to emissions have accelerated change within the energy sector with, in our opinion, the Canadian energy sector positioned to benefit. What a difference a year makes.

Canada's Domestic Energy Market

Canadian energy companies face numerous challenges, some mentioned above but others include the exit of foreign investment from Canada, politics, lack of egress and environmental matters. Focusing on environmental matters specifically, long-established companies in Canada have been dealing with the reduction of greenhouse gas emissions (GHG), use of fresh water, reduced or elimination of flaring, and tailings reductions and reclamation, which have been ingrained within their business models for the better part of 10-20+ years. The five leading oil sand producers have spent more than $1B/year on environmental improvements since 2012, which has outpaced their global peer group on an equivalent per barrel basis for the past decade. Few Canadians outside of Alberta may know that the Canadian energy industry ranks at the top of global producers when it comes to ESG rankings. These companies are now embarking on the next environmental evolution of their business model, which is linked to returns for shareholders and our global environment.

© Sionna Investment Managers. All rights reserved.

Canada #1 in All Categories vs. Top Reserve Holders



Source: Yale Environmental Performance Index (EPI); Social Progress Imperative; World Bank Governance Indicators, BMO Capital Markets.

Two companies held across Sionna's strategies since this time last year include Suncor and Canadian Natural Resources (CNQ). As dominant oil sand producers, both companies aligned with Cenovus Energy, Imperial Oil and MEG Energy to form the Oil Sands Pathways to Net Zero initiative. These companies operate ~90% of oil sands production with an objective to "achieve net zero greenhouse gas (GHG) emissions from their oil sands operations by 2050", which is the first major step for Canada to meet its climate aspirations under the Paris Agreement and net zero 2050 aspirations. The 'Pathways' announcement is the first collaborative large-scale proposed project for announced emission reduction goals from industry, and the Governments of Alberta and Canada. Incentives for the framework are being finalized between industry and government for large-scale Carbon Capture, Utilization and Storage (CCUS), which encompasses multi-sector emitters, not just oil sand companies. Allowing all industry emitters access to the proposed trunk pipeline system that will transport carbon dioxide (CO_2) for storage and/or enhanced oil recovery, should improve scale and hence the economic returns for all. CCUS technology has been employed in Canada for the past 20 years, with Canada operating 7 of 26 global facilities and accounting for more than 17% of global CCUS. The International Energy Agency (IEA) estimates the global market for CCUS will ramp up to ~5.6 Gigatonnes per annum (Gtpa) by 2050, an increase of 140-fold compared to today. To put these figures into perspective, ExxonMobil, a leader in CCUS, proposed the development of a CCUS project in Texas to capture ~50 million tonnes per annum (Mtpa) by 2030 and ~100 Mtpa by 2040 at a cost of over US$100B. Another 56 of these projects would be required to reach the IEA estimates by 2050 or ~$5.6T (not to mention the annual operating costs) to achieve an estimated 15% reduction in emissions.

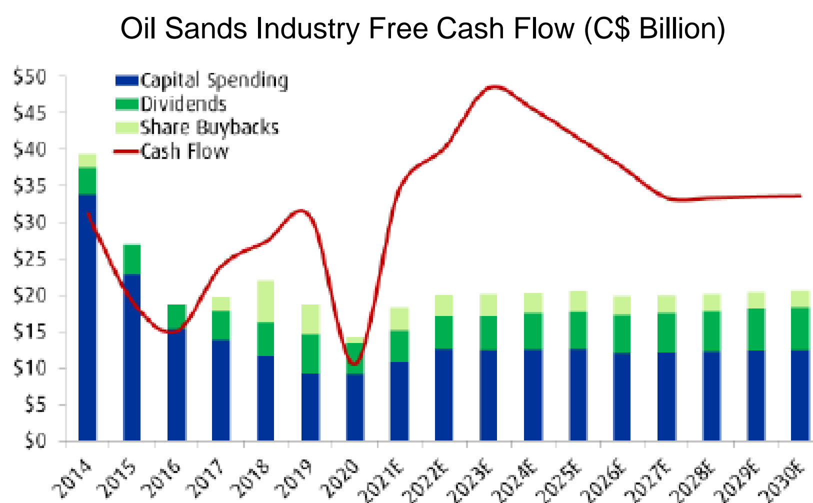
© Sionna Investment Managers. All rights reserved.

Alberta is well situated to become a central hub for Canada in CCUS development as ~57% of Canadian CO2 emissions reside in BC/AB/SK. Alberta's many strengths include: intellectual knowledge and an underutilized labour pool; great geology, including depleted energy reservoirs to saline formations for storage; a large infrastructure pool of existing pipelines and the potential to convert/build additional connection points.

Why does this matter? The energy industry continues to evolve and reinvent itself, as many industry experts believe energy transition will take decades to occur and a 'bridge' will be required from fossil fuels. Today, most global publicly listed energy companies, outside of OPEC, have begun re-allocating capital. Specifically, the majority are reducing growth capital, accelerating debt reduction, returning capital to shareholders (buybacks/dividends), and investing into emission-reduction projects with sufficient capital returns including renewables and the maintenance of their business.

Canadian oil sands companies are well positioned to capitalize on these initiatives; over the last decade the industry focused on R&D spending to help adapt to this current environment and has committed to additional investment to assist them in identifying how the future will unfold. Today, oil sand companies should benefit given the manufacturing nature of the operations, sustainable cost-reduction initiatives, move to digitization, and autonomous mine fleets just to name a few near-term drivers. Additional areas energy companies may transition include: renewable power generation (wind/solar/geothermal/tidal); hydrogen; ammonia; renewable natural gas; biofuels and charging/battery technology. The majority of capital spending over the past two decades was directed towards volume growth; it was recently more than $30B in 2014 but declined to ~$8B in 2020 as the industry transitioned towards optimizations and free cash flow generation. As illustrated by the following graph, this cash flow should provide the oil sands industry numerous options to allocate potentially significant capital to emission-reduction investments and shareholder returns.

Oil Sands Industry Free Cash Flow (C$ Billion)



Source: BMO Capital Markets. Based on corporate results of SU, IMO, CNQ, CVE and MEG; Excludes the impact of debt repayments.

© Sionna Investment Managers. All rights reserved.

As broad stock market valuations remain above long-term averages, we at Sionna are constantly seeking under-appreciated and/or misunderstood businesses – like Canadian energy, which continues to be mispriced in the market by both domestic and foreign investors. Specifically, our bottom-up analysis of our investments in energy producers Suncor and CNQ have performed well for our investors over the past year and remain at significant discounts to our estimates of their intrinsic values today. As Suncor and CNQ navigate their way through an energy transition, they continue to strengthen their financial positions by paying down debt and thus improving their future competitive positions.

We wish you a long, happy, healthy summer and appreciate your continued support.

Aleksy Wojcik, CFA
Portfolio Manager
Sionna Investment Managers

Sionna Investment Managers 8 King Street East, Suite 1600 Toronto, Ontario M5C 1B5
For further information, please email clientrelations@sionna.ca.

The contents of this document are not intended to serve as advice, recommendations or an offer to sell any product or service. This communication is for information only and should not be regarded as a sales communication. Readers should seek qualified professional advice before acting on any information provided in or through this document.

© Sionna Investment Managers. All rights reserved.