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# Energy Investing in an Uncertain World

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The year 2020 began with West Texas Intermediate (WTI) oil prices trading in a well-established range of US\$50-\$60 per barrel and markets were comfortable that while supply and demand were not in perfect balance, there were enough levers that could be manipulated to prevent any significant or lingering damage to the fundamentals. The underlying valuations of many energy producers were attractive, with many well positioned to carry out reasonable capital programs, maintain balance sheet flexibility, and still make expected dividend distributions.

The world changed dramatically in March and since then energy equity markets have been buffeted by the combination of an unprecedented collapse in global demand due to the spreading COVID virus, and a confused, sub-optimal, production response from Organization of the Petroleum Exporting Countries (OPEC), which resulted in a breakdown threatening the underlying foundation of crude oil financial markets.

## COVID Delivers Demand Destruction

The major issue facing energy investors is the impact of the spreading COVID virus on global demand for refined products, and thus indirectly crude oil. The initial period of quarantining and the resulting shutdown of many economies is estimated to have reduced demand in the range of 20-30%, or between 20 and 30 million barrels per day. As economies come back on line it is estimated that the persistent impact on global demand could be around 10 million barrels per day reflecting lower industrial demand, declining transportation demand, particularly aviation fuel and Heavy Fuel Oil (HFO) for shipping, and to a lesser degree automotive gasoline which is expected to rebound more quickly. It is important to note that these estimates are subject to revision as the full extent of the pandemic continues to unfold.

## OPEC's Muddled Response

The secondary issue investors are dealing with has been the response to this crisis by OPEC, whose primary role is to generate price stability in global oil markets through control over the marginal barrel of oil supply. As the virus spread Saudi Arabia, OPEC's leader and largest producer, convened an emergency meeting but failed to cement an agreement to reduce production. The Saudi's responded with a spiteful and ill-advised strategy to flood markets with incremental supply with the dual intent of grabbing market share and bringing other producers into agreement. This decision quickly proved disastrous as oil prices slid and the cartel was forced to cobble together a panicked agreement including both OPEC and non-OPEC players which, on paper, will remove more than 10 million barrels from daily supply. Unfortunately, the agreement does not come into force until the beginning of May and like most OPEC past agreements, the level of compliance is uncertain.

## The Emergence of Negative Oil Prices

OPEC's abject failure to adequately balance supply and demand has left near term markets massively oversupplied and unwanted barrels scrambling for limited storage capacity – much like children scrambling for the last chair once the music stops in musical chairs. Participants in the global crude oil markets can be broken into two broad groups, industry players that either produce crude oil or manufacture refined products

for end users, and financial players that in most circumstances, have no intention or capability of taking delivery of the oil and who must trade their positions to ensure they don't need to. In the current market turmoil storage options are scarce and as the most recent oil contract approached expiry many of these financial participants were faced with being forced to take physical delivery while traditional end buyers (i.e. refiners) were exiting the market. To avoid this, they were forced to pay others to take delivery – hence the occurrence of negative pricing for crude oil. In our view there is a chance this scenario could happen again as the next contract expiry approaches late in May and available storage could be even more constrained than it currently is. The only way to avoid running out of storage capacity over the next few months is to drastically reduce production and leave the oil in the ground – which should begin to happen as the announced cuts from the recent OPEC agreement are implemented and, weak prices force other production to shut-in. In Canada it is estimated that low prices could force a reduction in oil production in excess of 1 million barrels per day and in the United States up to an additional 3 million barrels of daily supply could be removed. An old saying is that the solution for low oil prices is low oil prices and that is the current situation as market forces work to re-establish a more stable supply/demand balance.

### **Equity Investing in a Maelstrom**

This extraordinary overlay of events has put the economic viability of most of the Canadian energy sector in jeopardy and made investing in the sector challenging. With WTI prices currently below US\$20 per barrel Canadian producers are receiving single digit oil prices in Canadian dollar terms for their best quality crude oil. Depending on how long the oil price remains low, we fear many companies could go bankrupt or at a minimum will be forced to significantly cut spending (capital and operational) and drastically cut or eliminate dividend payments. Many producers, particularly smaller ones, are seeing credit ratings lowered and in many cases access to capital has been eliminated. Obviously, companies with high debt levels are in deeper trouble than those with more pristine balance sheets but regardless the overall financial position of the industry is weak, and in our view, likely to further deteriorate over the near term.

No Canadian energy companies have low enough operating costs to withstand \$20/barrel pricing for any length of time, but the best positioned will be the Integrated Oils (Imperial Oil, Husky Energy, Suncor and Cenovus) that have refining and marketing operations that will still generate cash flow. There has been collateral damage to other sectors including the energy infrastructure sector and to a lesser degree the larger pipeline companies as some of the producers may be forced to default on pipeline and other infrastructure commitments.

### **Our Investment Response**

As the risk-reward balance in the Canadian energy shifted, the Addenda Capital Canadian Equity team moved quickly to reduce portfolio exposure. In Concentrated mandates exposure to energy producers (including integrated companies) was eliminated and within the larger CORE mandates, positions were reduced to less than half the S&P/TSX benchmark weight, holding only Suncor Energy. Within the pipeline and energy infrastructure sectors some positions were eliminated and overall exposure was reduced with a sharper focus on companies with financial positions appropriate to manage their way through the storm.

Going forward, our analysis suggests that as demand begins to return to “normal” and supply is removed (either voluntarily or not) global oil markets will ultimately return to balance, allowing prices to move higher. We are closely monitoring and analysing each company's response to the new environment and assessing underlying valuations under several potential pricing scenarios. As opportunities present themselves we expect to cautiously rebuild our exposure to the sector focussing on companies that are both trading at an attractive valuation relative to underlying intrinsic value under our base case oil price scenario and are also in a suitable financial position able to withstand a prolonged period of lower than normal prices. A quote often used in the world of motorsport is appropriate for today's energy investment environment and our current approach to portfolio construction...

***“The race is long – to finish first, first you must finish”***

– Garth Stein, New York Times bestselling author.