Edward Jones
MAKING SENSE OF INVESTING

# Investing in Energy (Canada)

**ENERGY SECTOR REPORT**

August 21, 2020


## ANALYST(S)

**Jennifer Rowland**, CFA


**Buy-rated energy stocks (subsectors and industries noted):**

**Oil, Gas and Fuels Subsector:**

Integrated Oil & Gas:
- **Chevron (**CVX - US$86.39)
- **Suncor** (SU.TO - $21.87)
- **Total SA** (TOT - US$39.09)

Storage and Transport:
- **Enbridge** (ENB.TO - $43.32)
- **ONEOK** (OKE - $27.86)
- **Pembina** (PPL.TO - $35.41)
- **TC Energy** (TRP.TO - $65.22)

Refining and Marketing:
- **Marathon Petroleum** (MPC - US$37.18)
- **Valero** (VLO - US$54.26)

Prices and opinion ratings as of market close on 8/19/2020; subject to change. Source: Reuters.

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## Energy Sector Investment Summary


The energy sector outlook remains challenging given the low-oil-price environment. The near-term outlook for oil prices is weak, as the oil inventories have built rapidly and will likely remain elevated into 2021, which will keep a lid on oil prices. A prolonged downturn in prices could lead to significant balance-sheet stress, production declines and dividend reductions for some companies. We are most concerned about the health of companies in the exploration & production and equipment & services subsectors. While the near-term outlook is challenging and we expect significant volatility to continue, we remain focused on owning stocks in the integrated oil, storage & transportation, and refining & marketing subsectors over the long term, where companies have strong balance sheets that allow them to weather commodity-price weakness and support dividends.


### Key Investment Points

**Oil prices at challenging levels -** Although recovered from recent lows, oil prices remain at levels that are challenging for many North American producers. We see the near-term outlook for oil prices as weak, as oil inventories have built rapidly and will likely remain elevated well into 2021, which will keep a lid on oil prices.

**Uncertain oil demand outlook -** Global oil demand has weakened significantly due to the impact of the coronavirus. While demand could recover in the later part of 2020, global oil demand for the full year is expected to decline sharply. Longer-term, the pace of oil demand growth is uncertain given the global transition to low-carbon fuels.

**Poor performance hurts investor interest -** The energy sector has delivered poor stock performance over the past decade given low profitability and weak oil and natural gas prices. We think investor interest in the sector remains low because of its poor track record and relatively high volatility.

**Dividends supported by those with strong balance sheets -** Only those companies with strong balance sheets will be able to support dividends during this period of severe commodity-price weakness. We expect dividend cuts across the exploration & production and energy equipment & services subsectors. For the most part, we see current dividends supported by strong balance sheets in the integrated oil & gas, storage & transport, and refining & marketing subsectors.

**Risks -** Primary risks of investing in the energy sector include volatile commodity prices; changes in demand; and political, environmental, currency, regulatory, and legal risks.


**Please see important disclosures and analyst certification on page 5 of the report.**

## INVESTMENT SUMMARY

The outlook for the energy sector remains challenged in the short term given the low-oil-price environment. The near-term outlook for oil prices remains weak, as oil inventories have built rapidly and will likely remain elevated into 2021, which will keep a lid on oil prices. Oil prices are at uneconomic levels for most North American producers, which need prices to be at least US$45 per barrel to be profitable. A prolonged downturn in prices could lead to significant balance-sheet stress, production declines and dividend reductions for some companies. We are most concerned about the health of companies in the exploration & production and energy equipment & services subsectors. While the near-term outlook is challenging and we expect significant volatility to continue, we remain focused on owning stocks in the integrated oil, storage & transportation, and refining & marketing subsectors over the long term, where companies have strong balance sheets that allow them to weather commodity-price weakness and support dividends.

## KEY CHALLENGES

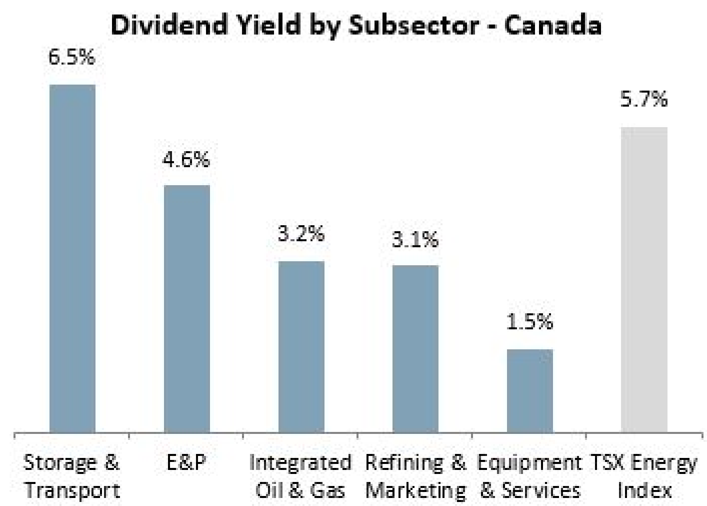
**Oil prices at challenging levels for North American producers.** Although recovered from recent lows, oil prices remain at levels that are challenging for many North American producers. Oil inventories have built rapidly around the world and will likely remain bloated well into 2021, which will keep a lid on oil prices. Longer-term, we expect oil prices in Canada to range between US$30 to US$50 per barrel and natural gas prices to range between US$1.00-US$1.75 per thousand cubic feet, reflecting the volatile nature of the commodities, because large price swings are common. In the short term, we expect oil prices to be below this range.

**Uncertain oil demand outlook, both near-term and long-term.** Global oil demand was weakened significantly due to the negative economic impacts of the COVID-19 pandemic. While demand is expected to recover in the later part of 2020, global oil demand for the full year is expected to decline sharply. Longer-term, the pace of oil demand growth is uncertain given the global economy's transition to low-carbon fuels. We expect continued growth in oil and natural gas demand for the next decade, potentially plateauing after that for oil, as the global economy transitions away from fossil fuels.

**Poor historical performance hurts investor interest.** The energy sector has delivered poor stock performance over the past decade given low profitability and weak oil and natural gas prices. As a result, the energy sector's overall share of the TSX has declined from over 33% in 2008 to approximately 13% today. We think investor interest in the energy sector remains low because of its poor track record, relatively high volatility, and skepticism towards companies' ability to generate positive free cash flow.

## KEY POSITIVES

**Compelling dividend yields for those with strong balance sheets.** Only those companies with strong balance sheets will be in a position to support their dividends during this period of severe commodity-price weakness. We have seen numerous dividend cuts across the exploration & production and energy equipment & services subsectors in 2020. We see current dividends supported by strong balance sheets in the integrated oil & gas (except for ExxonMobil, whose dividend outlook we have as At Risk), storage & transport, and refining & marketing subsectors. Given the sharp decline in oil prices, we expect the companies to tap the brakes on share repurchases, and we do not expect further dividend increases until oil prices recover to more economic levels.



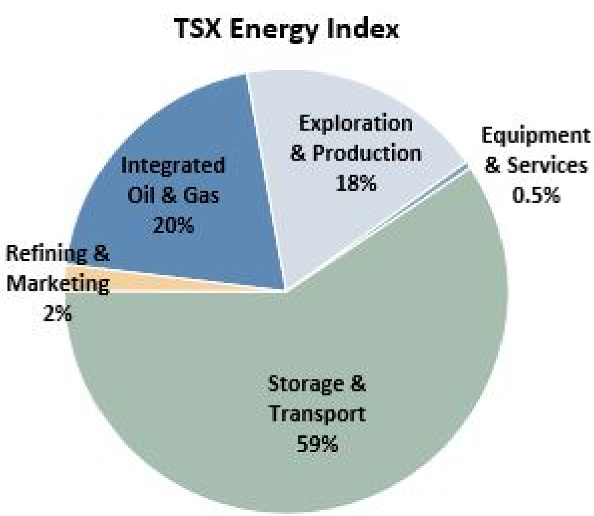

Source: FactSet. Data as of 8/18/2020. The TSX Energy Index is composed of 24 companies included in the TSX that are classified as members of the energy sector. The energy subsector indexes are subsets of the TSX Energy Index. Past Performance is no guarantee of future results.

**Valuation below average.** The energy sector is trading below its historical averages, but the discount varies by subsector. Compared with the 10-year historical average price-to-cash-flow ratios, the exploration & production and energy equipment & services subsectors are trading 10% to 30% below average. Despite these steep discounts, we view these subsectors unfavourably given the challenges of weak commodity prices and a struggle to regain investor interest after years of poor returns. The integrated oil & gas, refining & marketing, and storage & transport subsectors are trading 10% to 25% below average, which we see as compelling given their strong balance sheets and focus on returning cash return to shareholders over the long term.

## HOW TO INVEST IN THE ENERGY SECTOR

We recommend that energy stocks comprise 7% of an investor's equity portfolio.

There are key differences between energy subsectors, and we encourage clients to establish a base of holdings with the larger, more diversified integrated oil & gas companies. Due to their diversified operations, integrated oil & gas companies tend to have less volatile earnings and share prices while offering attractive dividend yields well above the market average. Integrated oil & gas stocks also tend to hold up better when oil prices are falling. However, they also tend to not rise as much as other energy stocks when oil prices are rising. Stocks from the other subsectors can serve to complement integrated oil & gas stocks in a portfolio because they tend to offer more growth and perform better in a rising oil-price environment. Energy stocks can be very volatile given the commodity-sensitive nature of cash flows.

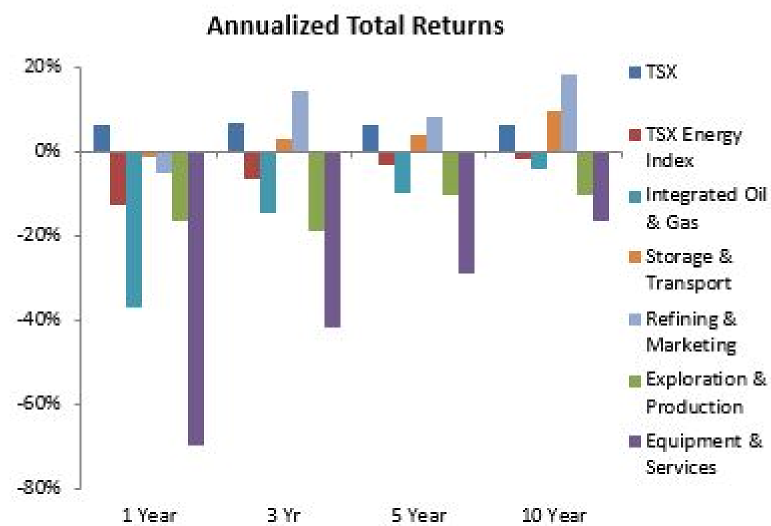



Source: FactSet. Data as of 8/18/2020. The TSX Energy Index is composed of 24 companies included in the TSX that are classified as members of the energy sector.

We prefer companies with a strong financial position, positive free cash flow, a competitive dividend yield, and a solid track record of dividend growth. We prefer energy stocks in the integrated oil & gas, storage & transportation, and refining & marketing subsectors that exhibit these characteristics. We think the exploration & production and the energy equipment & services subsectors will continue to underperform. **See the list on page 1 for all of our Buy-recommended energy stocks.**

We view the current valuations of the energy stocks listed on page 1 as attractive. Methods used to evaluate the attractiveness of energy stocks include price-to-cash flow (P/CF); enterprise value (market capitalization plus debt) to earnings before interest, taxes, depreciation and amortization (EV/EBITDA); and discounted cash flow analysis. Most of the energy sector is highly capital intensive, and these significant capital expenditures result in high levels of noncash depreciation charges that depress earnings. As a result, traditional valuation measures like price to earnings (P/E), price to book value (P/B), and P/E to growth and dividend yield (PEGY) are not applicable for most stocks in the energy sector.

### Energy Sector Performance Varies by Subsector




Source: FactSet as of 8/18/20. The TSX Composite is based on the average performance of 221 widely held common stocks. The TSX Energy Index is composed of 24 companies included in the TSX that are classified as members of the energy sector. The energy subsector indexes are subsets of the TSX Energy Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

### Subsector Descriptions

### Integrated Oil & Gas:

Integrated oil & gas companies offer size, scale, strong balance sheets, and geographically diverse operations. These companies typically operate in all segments of the energy value chain, with a large focus on the upstream and downstream segments, which provides diversification benefits, as upstream benefits from rising oil prices while the downstream tends to be hurt and vice versa. Companies typically have chemical operations as well as operations in liquefied natural gas (LNG). Integrated oil & gas stocks tend to pay higher dividends, offer less growth over time, and tend to be less volatile in the longer term. They tend to outperform when oil and natural gas prices are falling and underperform when oil and natural gas prices are rising. Investors tend to own them for the dividend and stability when the industry is out of favour. Integrated oil & gas stocks we recommend with a Buy rating are **Chevron, Suncor and Total**.

**Storage & Transport:**

The storage & transportation subsector, commonly referred to as "midstream," encompasses the piece of the energy value chain that comes after the exploration and production of oil and natural gas. It consists of the gathering, processing, transportation and storage of oil and natural gas. The transportation of commodities is done via pipeline, truck, rail and barge. Many of the midstream assets are regulated or under long-term fee-based contracts. With minimal direct commodity-price exposure, companies in this subsector have relatively stable and predictable cash flows. This allows them to pay out a large percentage of their cash flow as dividends. The midstream stocks we recommend with a Buy rating are **Enbridge, ONEOK, Pembina and TC Energy**.

**Refining & Marketing:**

Refining & Marketing (R&M) companies purchase oil, turn it into finished products such as gasoline, diesel, heating oil and jet fuel, and then sell them to consumers. This segment is referred to as "downstream," which is the final stage in the energy value chain. Refiners have significant commodity-price exposure because they purchase oil and sell products that can see prices move separately from oil. These stocks also tend to be more economically sensitive than other energy stocks. Relatively low capital-spending requirements result in significant free cash flow generation, which is being returned to shareholders via dividend increases and share repurchases. R&M stocks we recommend with a Buy rating are **Marathon Petroleum and Valero**.

**Exploration & Production:**

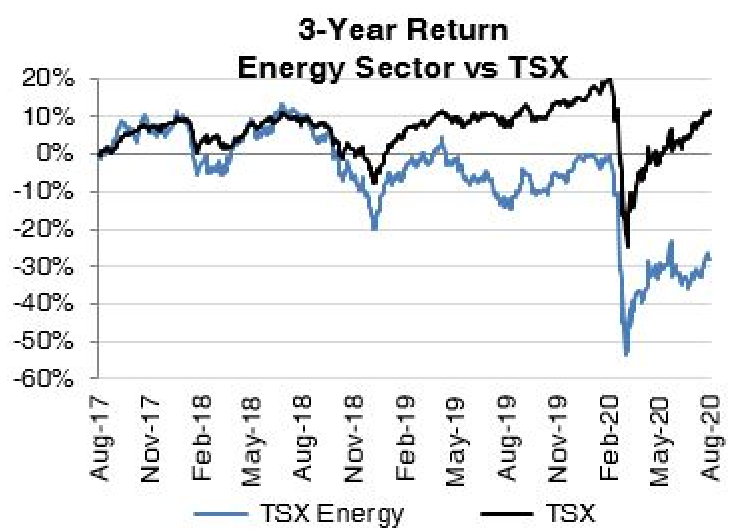
Exploration & production (E&P) companies explore, drill wells and produce oil and natural gas. This segment is referred to as "upstream," which is the first stage in oil and gas development. The E&P companies we cover are primarily focused in North America. Since these companies produce and sell oil and natural gas, they have direct commodity-price exposure, and cash flows can be very volatile and unpredictable. These stocks tend to outperform when commodity prices rise and underperform when commodity prices fall because they do not have other operations to provide diversification benefits. We see the commodity-price environment as increasingly challenged, as oil prices suffer from continued oversupply combined with an uncertain global demand outlook, while natural gas prices are negatively impacted by oversupply. This creates a difficult backdrop for exploration and production companies. We do not have any Buy-rated stocks in this subsector.

**Energy Equipment & Services:**

The energy equipment & services subsector provides drilling and production equipment and a variety of services that are needed in the upstream segment. Profitability is tied to the capital-spending programs of oil and natural gas producers, which in turn is tied to commodity prices. Spending on drilling activities is down sharply from peak levels experienced in 2014, and we do not expect the industry to return to prior peak cycle levels for revenue or margins for the foreseeable future. We think the energy equipment & services subsector will continue to underperform the broader energy sector because we see the commodity-price environment as increasingly challenged. We do not have any Buy-rated stocks in this subsector.

**Please see the full opinions of the individual companies for additional information, including disclosures, valuation and risks specific to each company.**

**SECTOR RELATIVE PERFORMANCE**




Source: FactSet as of 8/18/2020. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results. The TSX Composite is based on the average performance of 221 widely held common stocks.

The TSX sector indexes are subsets of the TSX. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

The TSX Energy Index has underperformed the broader market over the last three years due primarily to low profitability and weak oil and natural gas prices.

## Required Research Disclosures

### Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.
Jennifer Rowland, CFA

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An index is not managed and is unavailable for direct investment.

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