The continued case for Canadian energy

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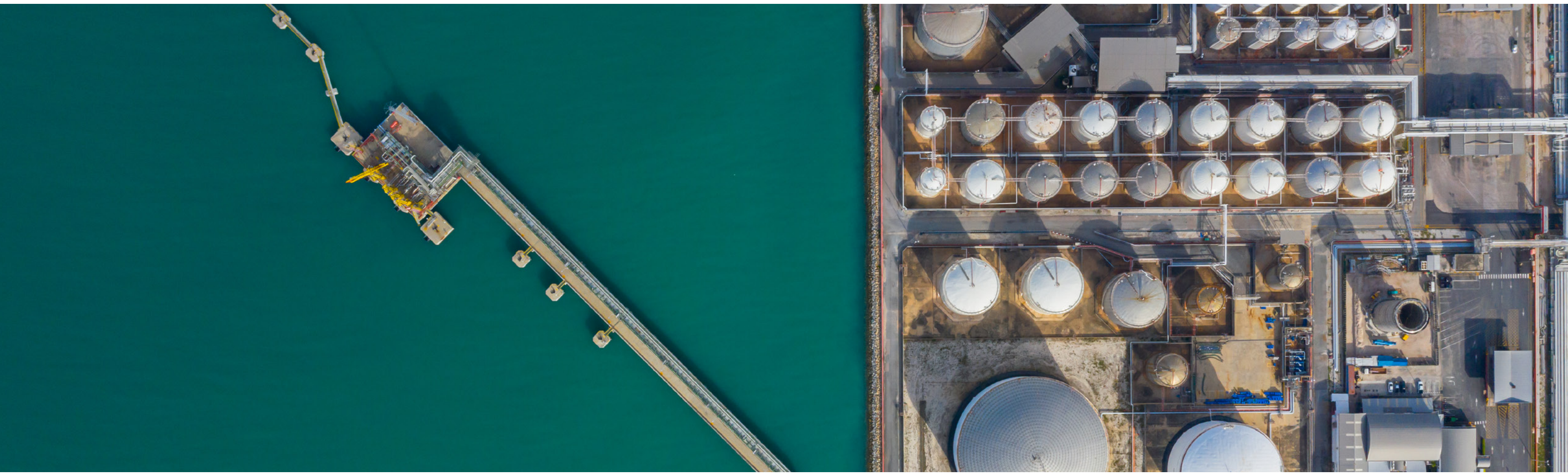


Introduction

Canadian energy has enjoyed a rebound throughout the last three years driven by the Russia/Ukraine crisis, renewed collaboration amongst OPEC members, and a lack of global investment in new supply. After the sector's impressive upswing, many are torn whether we can expect a reversal in fortunes, or a continued uptrend. Historical energy bull markets have seen rapid price increases only to be followed by cyclical busts. This report intends to illustrate why this energy bull market cycle could be different than other ones historically. While the energy sector will always be inherently volatile over shorter time frames, we expect continued strength in the Canadian energy sector over the medium to long-term.

How long have energy bull markets lasted?

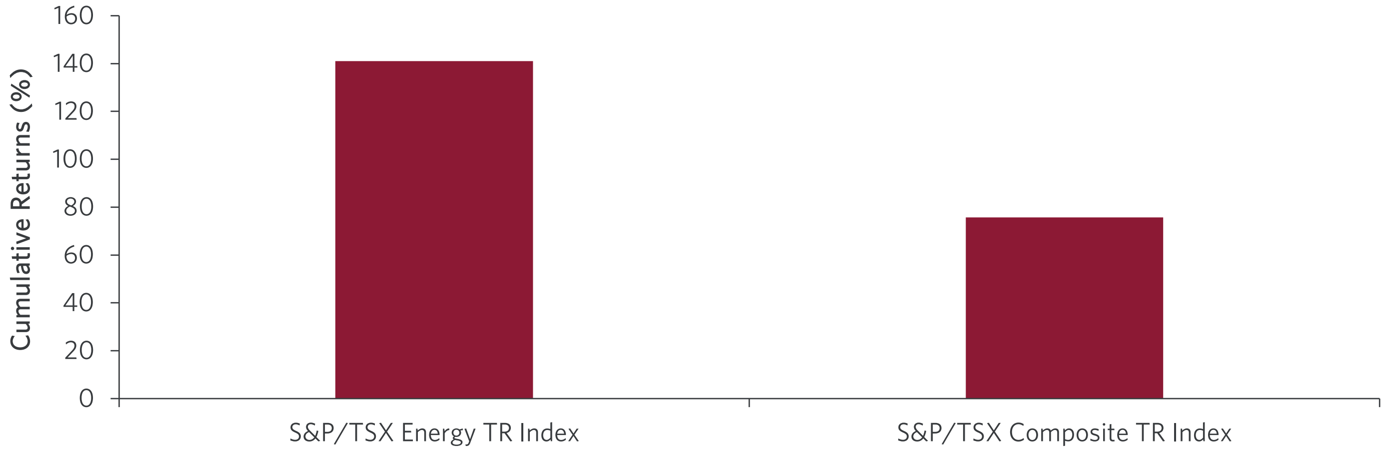
To provide context, it's important to compare the current energy bull market to others experienced over the last 60 years. Prior to the current run, there have been four other energy bull markets that have lasted an average of 92 months. Over those periods, the average cumulative return was approximately 398%.

Time Period	Duration (Months)
1960 to 1969	108 Months
1974 to 1981	80 Months
1999 to 2008	112 Months
2009 to 2014	67 Months
Average	92 Months

Source: Bloomberg, Peters & Co, CIBC Asset Management, 2023

The current energy bull market started in April 2020 and, as of the time of writing, has lasted around 45 months. Since April 2020 the Canadian Energy sector has experienced a cumulative return of 141%, outperforming the broader S&P/TSX Composite which returned 76%.

Cumulative returns: 4/1/2020 – 12/31-2023



Source: Morningstar Direct as at December 31, 2023

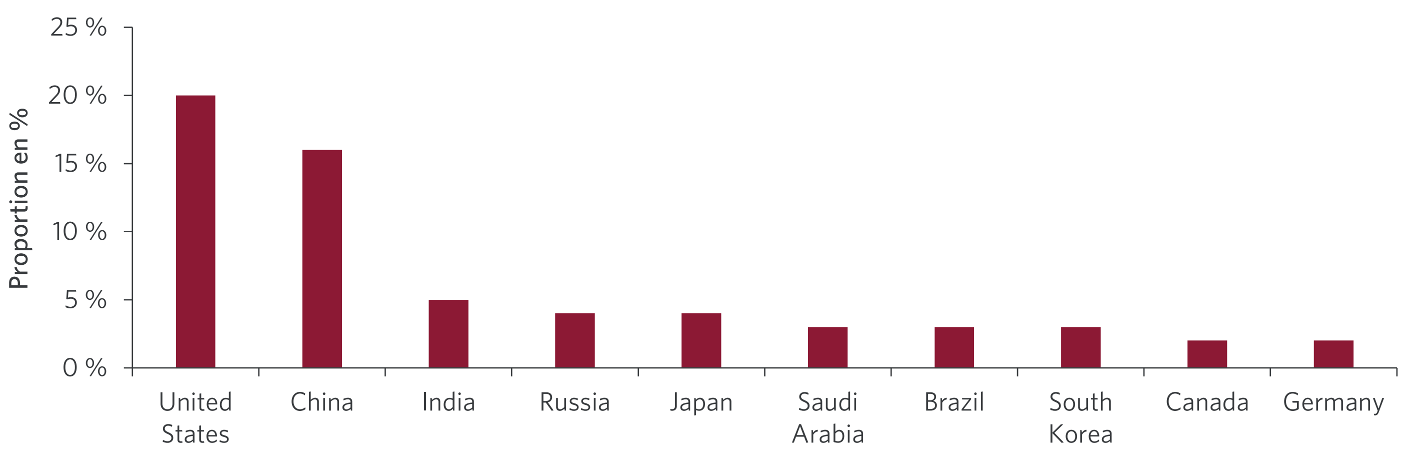
Comparing both the duration of these historical bull markets and the cumulative returns suggests that we are still in early innings.

Changing supply dynamics

Energy producers have undergone a significant paradigm shift over the last 5 years. Previously, CEOs were incentivized to expand their operations, identifying new reserves through exploration, and investing in new long-term projects. These capital projects were prioritized and approved at the expense of shareholder returns and the quality of the company's balance sheet.

When oil prices crashed in 2017, energy companies cut most or all capital projects in an effort to conserve cash, weather the storm, and in some cases remain solvent. Despite oil prices rebounding, we saw a muted supply response by energy companies. Energy companies often lack a clear view of long-term projects as a result of political risk (E.g.: Keystone Pipeline, U.S. policy changes), shifts in public sentiment, reputational risks, emergence of Environmental, Social, and Governance (ESG) initiatives, and indigenous land disputes. Moreover, lenders have been less willing to approve new oil & gas capital projects. As a result, company executives had very little incentive to push through capital projects resulting in the lowest oil and gas reinvestment in 40 years.

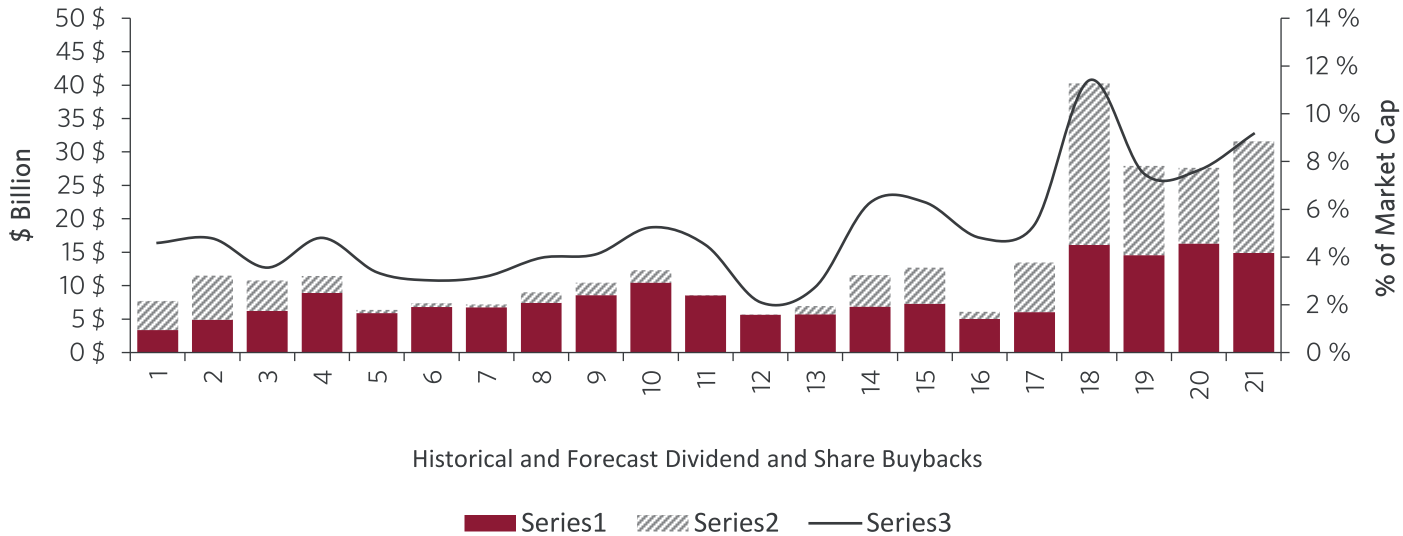
Global oil and gas investment has continued to decline



Sources: IEA, Refinitiv-Datastream, CIBC Asset Management calculations based on data available as of January 31, 2023.

Instead, most expansion projects undertaken in the last few years have been related to bottleneck projects such as liquified natural gas (LNG) pipelines. We've seen energy companies live within their means with the realization that debt needs to be more manageable and capital programs aligned with cashflows. Larger companies have adopted lower leverage models, targeting a one times Net Debt to Cashflow ratio through the economic cycle. Many executive bonuses are now tied to profitability and returns rather than growth. For example, shale producers historically would bring supply online as quickly as possible with executive compensation around 15% for growth initiatives compared to around 5% today. All of this has resulted in companies shifting from capital projects to returning free cash flow in the form of dividends and share buybacks.

Energy sector: Returning cashflow to shareholders



Source: Bloomberg, Peters & Co, CIBC Asset Management, July 2023.

In 2022 and 2023, energy company shareholders benefited from some of the most investor-friendly policies in the past 20 years illustrating changing dynamics within the industry. In the past few quarters, we've seen some of the largest Canadian energy producers commit to significant dividends and share buybacks. Additionally, once companies like Canadian Natural Resources, Cenovus, and Suncor hit their debt reduction targets, their plan is to return 100% of free cash flow to shareholders in the form of share buybacks, base dividends, and special/variable dividends. Even if energy prices were to stay flat, investors are essentially getting paid to hold on to these companies which benefit from strong margins and conservative balance sheets. Ultimately, this illustrates the desire of Canadian energy companies to balance sustainable growth with a focus on shareholder returns.

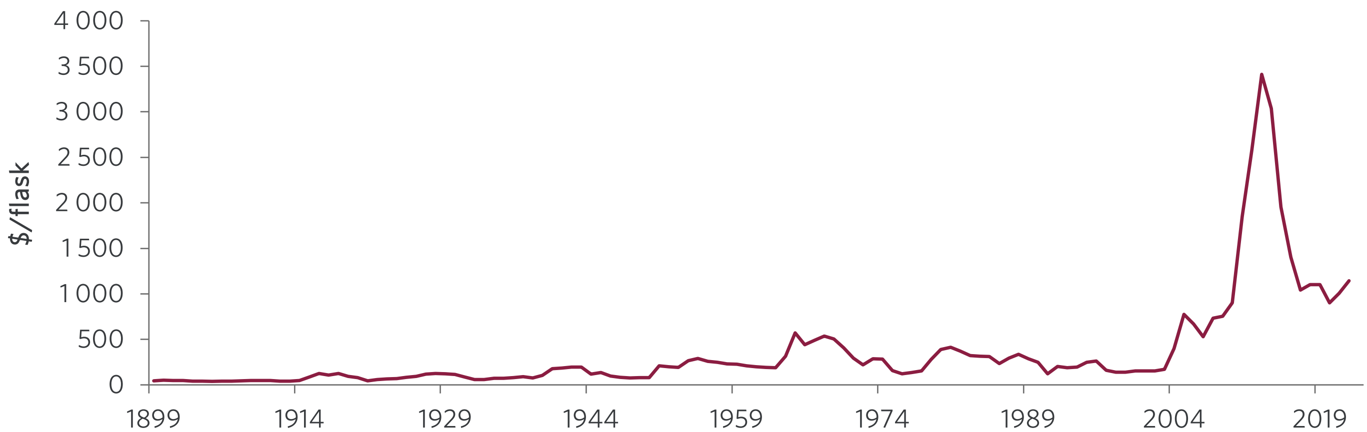
Canada in particular has some of the most unique supply dynamics in the world. We have the 3rd largest reserves globally, and the oil sands are responsible for over two-thirds of our overall production. Shale in the U.S. requires constant discovery, capital expenditure, and drilling to maintain production. In contrast, Canadian oil sands production requires significant upfront capital investment, but benefits from a minimal production decline rate and a 50-year runway for growth. Canadian energy companies don't need to invest in new growth initiatives to be profitable. Even if we never have another oil sands project approved in Canada, Canadian energy producers have decades of supply available with little marginal cost.

The long term supply-demand equilibrium

Taking a multi-decade view, commodities that get phased out do not simply get eliminated from the market, with prices falling to zero. As supply decreases and new investment projects are curtailed, it sustains the price over an ultra-long period of time, and in some cases, causes a surge in the price realized.

Mercury is a great example of a commodity for which demand has slowly declined over time. Historically, it was used in hundreds of applications such as assessing temperature prior to the modernization of thermometers. As applications for mercury dwindled, so too did investments in the commodity.

Increasing mercury prices over multiple decades



Source: BMO Capital Markets & USGS as at February 13, 2024

While the price of mercury initially fell, as supply decreased, the price found long-term footing. Today, there is consistent demand for mercury albeit lower than historically, while the price has remained resilient, increasing over the last 20 years. This is a great example of what we can expect for oil over the ultra-long-term. As supply reaches its inflection point over the next few decades, this will likely cause oil prices to stabilize or increase allowing for continued profitability of energy companies.

The return of the OPEC cartel

Similar to the North American energy market, there has been a lack of investment in spare capacity within OPEC. Towards the end of 2022, United Arab Emirates and Saudi Arabia were the only countries with excess capacity. Countries within the union have become more price conscious since the 2017 oil market downturn and are more diligent at maintaining a profitable price of oil.

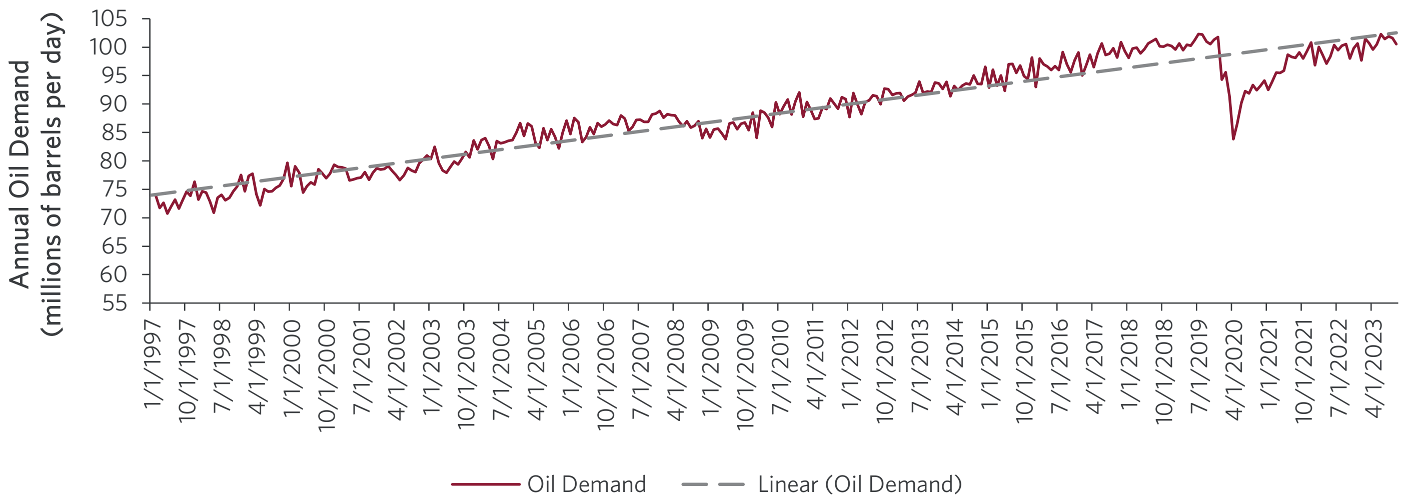
Prior to 2017, OPEC had less of an ability to control prices. If they cut supply and boost prices, U.S. Shale producers would fill the supply gap and quickly obtain market share from OPEC. Conversely, if OPEC increased supply, they would drive the price of energy to potentially unprofitable levels. In early 2020, that is exactly what happened. During the beginning of the global pandemic OPEC kept supply high despite a worsening global economic outlook. This brought WTI and Brent oil prices to effectively zero for short-term contracts, forcing many shale producers to take their operations offline given the unprofitability of each barrel of oil.

Since 2020, many shale producers have depleted more productive tier 1 reserves and have abandoned exploration initiatives. This gives OPEC greater pricing control, keeping oil prices within a tighter band and maintaining profitable margins. OPEC countries have been more cohesive in their negotiations and adherence to output targets. As long as group unity continues, energy trading within a narrow band will likely persist. On the high end, OPEC will try to avoid prices that result in demand destruction. On the low end, OPEC can cut supply to maintain profitability. In 2023, OPEC managed supply on multiple occasions, keeping oil within a $60-$90 range. Ultimately, this can reduce oil price volatility, and increase the duration of the current cycle.

Has demand for energy changed?

Despite popular opinion suggesting imminent demand destruction for oil, there are many reasons to forecast continued demand over the long-term. Throughout the last 40 years, demand for oil has largely mirrored both GDP and population growth, with both expected to continue their upward ascent.

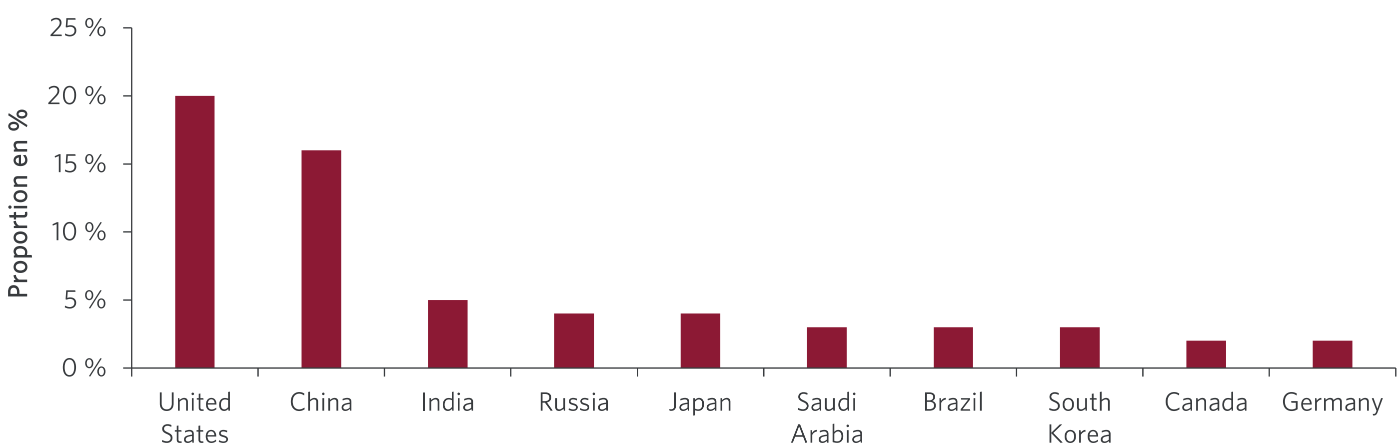
Consistent oil demand growth



Source: Data from the U.S. Department of Energy's Energy Information Administration's monthly Short Term Energy Outlook report

In 2023, global energy consumption was around 101 million barrels per day (US Energy Information Administration, February 6, 2024). We believe demand will continue its upward trajectory for decades. Despite a slow transition to renewables in developed countries over the next 25 years, emerging markets will continue their reliance on oil as it is comparatively cheaper, and an easier way to increase their standard of living.

Share of world total oil consumption by country



Data source: U.S. Energy Information Administration, International Energy Statistics, Total oil (petroleum and other liquids) consumption, as of September 22, 2023

Oil consumption in China, India, Russia, Saudi Arabia and Brazil currently represents around 31% of total global demand. Emerging market demand is anticipated to be higher in the next 20 to 25 years driven by population growth and increasing demand for petrochemicals.

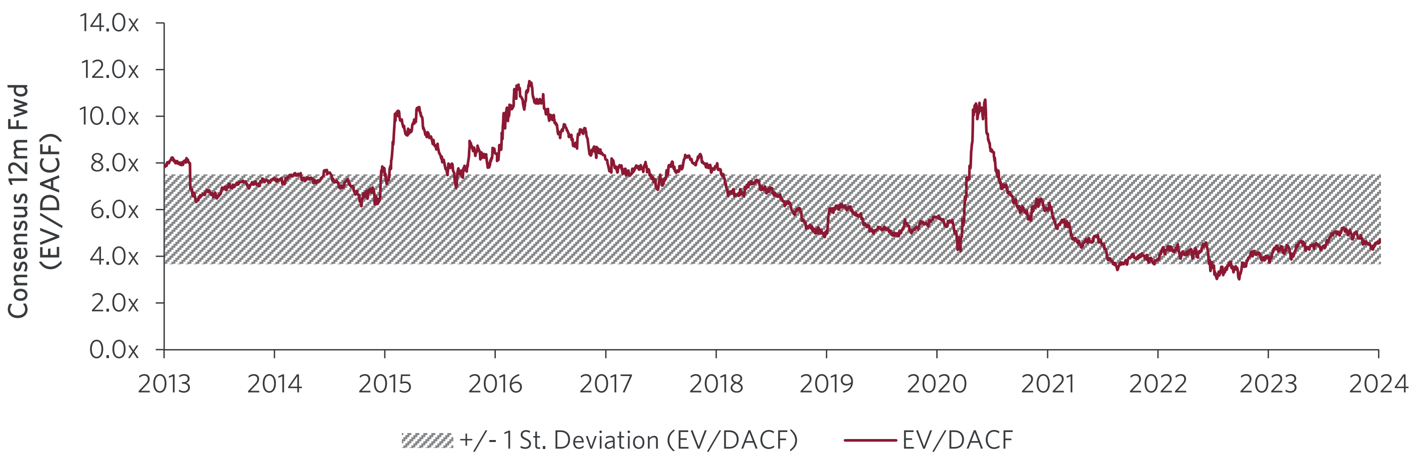
Over the long-term, one of the biggest headwinds affecting energy demand is electric vehicles (EVs). Currently the EV market has stripped around 1.8 million barrels of oil from current daily demand, representing an extremely small percentage of total daily demand at over 100 million barrels. By 2030, we anticipate the EV market will replace around 5 million barrels of daily oil demand.

We recognize there are headwinds to oil demand created by the electrification of the vehicle fleet. However, the EV market faces its own headwinds. The main inputs to create EV batteries are copper and lithium. Currently, there are no new major copper mines being discovered, and lithium prices have been soaring. This limits mass production of EV batteries. If the price of inputs continues to soar we see an inability for mass adoption in emerging economies, given the smaller middle class in comparison to developed countries. In our estimation, we believe there will be a gradual electrification of the vehicle fleet rather than an immediate replacement of combustible engines.

Attractive valuations of Canadian energy companies

Despite the stellar performance of Canadian energy companies since 2020, valuations remain historically low. Most investors are familiar with the Price-to-Earnings (P/E) ratio, which assesses a company's share price in comparison to its expected 12 month forward earnings. In the energy sector, a commonly used valuation ratio is the Enterprise Value to Debt Adjusted Cash Flow (EV/DACF) ratio. Many energy businesses have vastly different levels of debt, so this ratio standardizes the capital structure of these companies in order to create better comparisons.

Historical consensus valuations of Canadian E&P sector



Source: NBF, Company Reports, Bloomberg as at December 31, 2023

When using the EV/DACF ratio, we can see that energy companies continue to trade at the bottom of their valuation range or what is considered trough multiples over the last decade. Many investors have avoided investing in energy companies after what was experienced from 2017 to 2021. Furthermore, investors want to see them consistently prioritize shareholder returns before re-investing in the sector. We believe that as oil continues to trade within the $60 to $90 range, and Canadian energy companies remain profitable emphasizing dividends and share buybacks, we will see a reversion towards the mean.

How will Canadian Liquified Natural Gas projects cater to increasing global demand?

Liquefied Natural Gas (LNG) is a form of natural gas that is cooled to a liquid state, rendering it around 600 times smaller compared to its gaseous state facilitating shipment abroad. It is used in cooking, heating, electricity generation, among other applications. It is a lower carbon energy source in comparison to diesel or coal, and is a critical input for global energy consumption. Since the start of the Russia/Ukraine crisis, Europe has rapidly diversified away from Russia as its LNG provider. In Asia, China and many other countries need LNG to fuel their rapid growth.

Today, we forecast a third wave of LNG growth with North America leading the charge as the main provider globally. The share of LNG in the global gas supply is expected to increase from today's 13% to 23% by 2050 as it meets demand growth and replaces declining pipeline and domestic gas. (Source: Energy Insights: McKinsey: February 2021)

Historically, Canada has not directly shipped LNG to Asia and Europe, instead selling its supply out of the Gulf of Mexico. This has caused a massive price discount for Canadian LNG brought to the market. However, Canadian LNG will soon have direct access to foreign markets as projects like the Coastal GasLink pipeline near completion in 2024. In addition, many small LNG projects like Cedar LNG have been initiated with First Nations partnerships and will also help increase Canadian supply. All of these initiatives will help bring Canadian LNG to markets globally enabling Canadian energy companies to take advantage of better pricing in both Asia and Europe. We believe that LNG will be a major contributor to increasing global demand for Canadian production over the long-term.

Will ESG initiatives impact the energy sector?

Environmental, Social, and Governance (ESG) considerations have seen increased popularity amongst investors over the past few years as a way of assessing non-financial impacts, and lead change through engagement, voting, and investment action. While it is easy to label the energy sector as dirty and therefore not ESG friendly, there are many different types of initiatives underway to address these issues.

Overall we believe that any barrel of oil produced in Canada or North America is far better from an ESG perspective in comparison to places like Russia, Saudi Arabia, or Venezuela. Many of these countries suffer from poor human rights violations and environmental standards. Comparatively, in Canada, we have:

- Better regulations for methane emissions and policies on flaring
- Net zero targets by 2050, and actionable 2035 goals
- Oil sands pathway initiatives which implement ways to capture carbon from operations
- Numerous commitments to the 30% club which is a pledge to increase gender diversity on boards and senior management teams
- Technologies, like those shared by companies like Suncor, to reclaim tailing ponds – a byproduct of oil sands operations – and reduce emissions

We acknowledge that there is room for improvement in Canada. Carbon capture needs to be further developed, and greater detail must be shared on the roadmap to achieve 2050 goals. Furthermore, each individual Canadian company needs to be evaluated by each ESG factor when considering investment merit. However, we ultimately believe that Canadian companies are an ESG leader globally within the energy sector, and that further adoption will only serve to better these companies over time.

How to gain exposure to Canadian energy

At CIBC Asset Management, we have a number of portfolios and funds that provide exposure to the Canadian energy sector.

Craig Jerusalim, our longest tenured equity portfolio manager at CIBC Asset Management manages multiple diversified Canadian portfolios such as the Renaissance Canadian Growth Fund and CIBC Dividend Growth Fund. As at December 31, 2023, he has approximately 20% of his portfolio allocated to Canadian energy companies. This exposure is similar to his allocation to energy within the CIBC Imperial Equity High Income Pool, and the CIBC Imperial Canadian Dividend Income Pool, both components of the CIBC Personal Portfolio Services portfolios. As well, the CIBC Smart Investment Solutions portfolios have varying allocations to the Renaissance Canadian Growth Fund.

We invest in high-quality companies with strong management teams that trade at attractive valuations and are expected to outperform over the long-term. These companies have sustainable competitive advantages resulting in high profitability, consistent and predictable cashflows, and low leverage and variability. Many of the Canadian energy companies we are invested in today exhibit these characteristics such as Canadian Natural Resources, Suncor Energy, ARC Resources, Crescent Point Energy, among others.

Managed by Daniel Greenspan and Colum McKinley, with support from Leo Han, the CIBC Energy Fund is a fund comprised entirely of energy companies. This team invests in securities of Canadian companies involved in oil and gas and other energy-related products and services. Their goal is to understand key short and long-term energy supply and demand drivers, look for broad themes and secular issues not yet appreciated by the market that may impact energy prices, and then perform company specific analysis to determine the best opportunities within the industry.

Regardless of whether investing in a diversified Canadian portfolio, or sector-specific energy fund, we believe Canadian energy companies are an attractive investment over the long-term given the favourable demand outlook and changing supply dynamics.

If you'd like to discuss the insights raised in this article in more detail or have questions about your investment portfolio, please contact your advisor or CIBC representative anytime.

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At CIBC Asset Management, we believe that every customized investment solution begins with research and rigour. We specialize in a variety of investment solutions such as equities, fixed income, currency management, liability-driven investments, asset allocation, and responsible investments.

Across a spectrum of investment solutions, we commit to robust research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation. Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset-class teams. By sharing insight across asset class teams, we maximize opportunities to add value to our client portfolios.

Contact us anytime

To learn more about CIBC Asset Management and our investment solutions, please contact your advisor or your CIBC representative. For more insights, connect with us on LinkedIn and Twitter.