Canadian Energy Producers Seeking Patient Investors

Investment returns from companies in the Canadian energy sector have generally been disappointing for the past three years. The average Canadian energy stock has declined, underperforming its U.S. peers and the S&P/TSX Composite Index. Despite these results, there are opportunities for patient, long-term investors in the sector. Understanding the macro environment is essential. The U.S. is the main customer for Canadian oil. Due to improvements in drilling and fracturing technology, U.S. oil production has surged to a 20-year high. This has happened while U.S. oil demand has been stagnant, putting Canadian oil producers in a weak position.

Current U.S. oil price quotes around US$95 do not tell the whole story. Many Canadian producers are selling oil at a substantial discount to this price, which is commonly referred to as the differential. Their product is Western Canada Select, which consists mainly of bitumens from the oil sands. Some refineries cannot process this product, suppressing demand. According to Bloomberg, on Dec. 14, 2012, the differential hit a record US$42.50. More recently, the differential has been hovering around US$20, which is manageable, but is still a drag on results. Various Canadian parties are now scrambling to find a solution. The only long-term solution involves expanding oil transportation infrastructure to enable producers to access new markets. The economic stakes only grow as time passes, as Alberta oil sands output is expected to double by 2022.

One of the highest-profile pieces of proposed oil infrastructure is the Enbridge Inc. Northern Gateway Pipeline to B.C.'s west coast, a political lightning rod locally due to environmental risks. Competing for headlines is the proposed TransCanada Corp. Keystone XL pipeline from Alberta to the southern U.S. President Obama's administration has delayed giving approval, as various groups are lobbying against it. There is also the proposed expansion of Kinder Morgan Inc.'s Trans-Mountain pipeline from Edmonton to Burnaby, which seems likely to proceed. The Trans-Canada Corp. East Coast Option is a plan to convert the main Canadian natural gas pipeline heading east into an oil pipeline, increasing access to eastern markets. The Alberta and Northwest Territories governments are now discussing a pipeline connecting the oil sands with Tuktoyaktuk near the Beaufort Sea. Also, there are ongoing efforts to move more oil by rail and to expand heavy oil refining capacity.

In the longer term (three to 10 years), some of these projects may fail if the environmental risks are unacceptable, but some of them will inevitably be completed, potentially alleviating the differential. In the shorter term (one to three years), the differential and the moderately negative macro environment for Canadian energy producers could easily persist. Patient buy and hold investors should nonetheless consider adding shares of Canadian Natural Resources Ltd. (TSX:CNQ) and Cenovus Energy Inc. (TSX:CVE). These are large, well-managed Canadian companies that have the assets to grow their oil production substantially over the next decade. Cenovus' interests in U.S. refineries have helped it mitigate the effects of the differential.

Analysts estimate that Canadian Natural and Cenovus will generate cash flow of $6.45 and $5.03 per share in 2013, respectively. With both companies' shares trading around $30 at the time of writing, we believe valuations are low and offer long-term upside. Both companies pay dividends, which have been rising in recent years. We hold shares of these companies on behalf of Armstrong Schmidt clients and personally.

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