

The strip-tease in energy stocks: Are they real?

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The forward pricing strip in commodities futures is one of the most basic tools in the investor toolbox to assess valuations on energy stocks. But evidence shows it's a pretty blunt instrument.

Oil and gas analysts Sam La Bell and Michael Valicek of Veritas Investment Research examined crude oil's 12-month strip - the series of futures contracts expiring over a one-year period - going back to 1986. They found that the futures are a pretty poor predictor of what actual prices will be even a few months down the road, let alone a full year.

That's a strong word of caution for valuations of energy stocks, which are often gauged by anticipated cash flows 12 months down the road.

"Valuations of oil and gas companies using 12-month strip prices should be viewed with considerable skepticism, as they appear, at best, to be market-based guess-timates," they wrote in a research note.

THROWING INVESTORS A CURVE

A glance at the futures pricing curve for Nymex crude oil over the past year supports their argument. A year ago, the curve was telling investors to assume prices would ease slightly, but would still be north of \$105 (U.S.) a barrel around now. Six months ago, the curve suggested prices would now be topping \$70, on an upward trajectory headed toward \$80 to \$90.

But the reality has been quite different: Prices have fallen precipitously and have essentially flattened out in the \$40 to \$50 range.

Mr. La Bell and Mr. Valicek found that for futures contracts expiring much more than two months down the road, the odds that the contract price would be within 10 per cent of the actual price of oil at the time of expiration was below 50 per cent. Anything more than four months, it was less than 40 per cent.

However, the analysts also found that forward prices were "unbiased" - they were about as likely to significantly overestimate future oil prices as underestimate them. That means that as an indicator of "expected" value - a decent midpoint of possible outcomes - the forward strip provides a useful signpost of where positive and negative risks are more or less balanced.

RISKY BUSINESS

Mr. La Bell said the inaccuracy of the forward strip does expose valuations to downside commodity-price risk. He typically assumes commodity prices lower than what the strip indicates in calculating his own energy-stock valuations, as defence against a strip that proves too optimistic.

Right now, he said, investors aren't demonstrating this sort of caution with respect to Canadian energy stocks, which are up 30 per cent in the past two months.

"We think the market is valuing companies right up to the strip. They're pricing as if the recovery has already occurred," he said. "That's where the risk lies."