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The oil price outlook: A slippery slope for energy stocks

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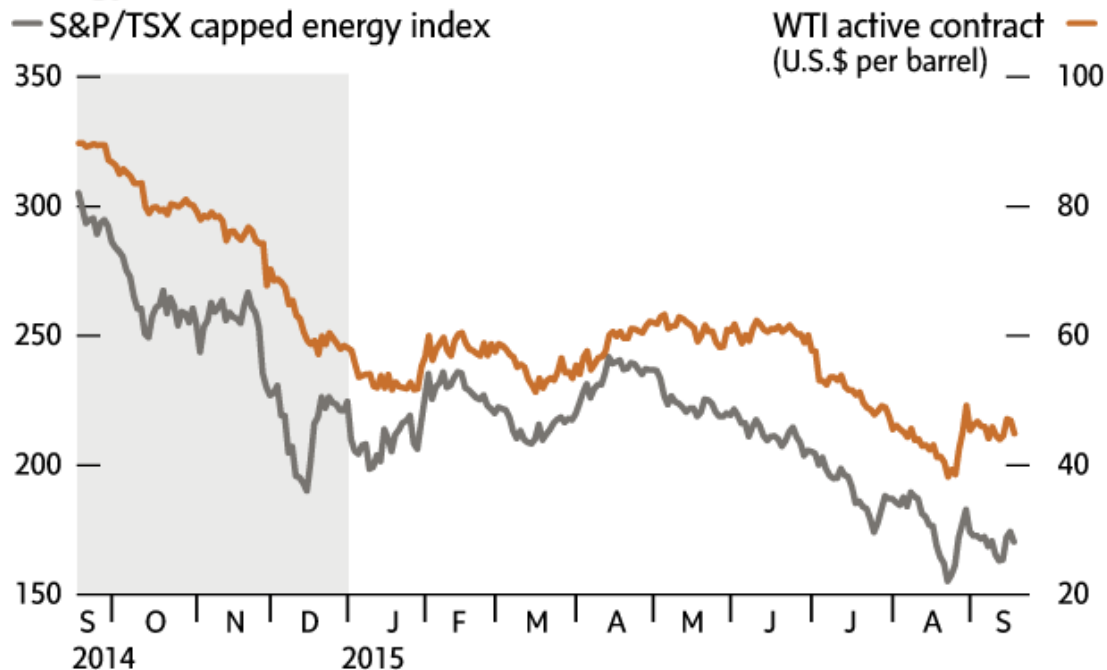
Early this year, investors may have thought they'd missed the buying opportunity in energy stocks. By early March, oil had rebounded from late January lows and small exploration and production companies, particularly, had zoomed on the optimism that the bottom was past.

The outlook has, shall we say, changed. The current expectation for prolonged weakness means the forecasts for \$75 (U.S.) per barrel oil in 2016 are gone.

Friday, RBC Dominion Securities cut its forecast for West Texas intermediate (WTI) crude to \$57 in 2016, from a previous \$72. Futures prices suggest oil will stay in the \$50 range for more than 18 months; and some forecasters say even this may be too rosy a scenario.

Even if oil prices trudge in this depressed range for some time, however, equity investors will experience a harsh reality: The bottom for oil prices is not the same as the bottom for energy stocks. As low-priced oil continues, companies face declining cash flow as their options for raising capital diminish. Those with the best balance sheets get wounded; the most debt-laden likely die. Over the next few months, investors will see which are which.

Energy stocks vs. WTI



JOHN SOPINSKI/THE GLOBE AND MAIL » SOURCE: BLOOMBERG

“Firms with strong liquidity positions and high quality assets can wait out low prices,” say the analysts at Citigroup Global [Markets](#), who analyzed producer survival in a report earlier this month.

“But injecting more capital into levered firms with poorer assets is simply pushing out the inevitable and creating conditions for investors to suffer losses.”

The analysts at **Veritas Investment Research**, in a recent report called “Canadian Oil and Gas Sector: Look Before You Jump,” note the decline in the Canadian energy index, which is down more than 20 per [cent](#) since the start of the year and 40 per cent since the end of last September, “has drawn more than its fair share of comparisons to 2009, with investors hoping for the same sharp [plus-50 per cent] rebound from the bottom that happened in that year.”

The comparison, however, “is fraught with problems,” as 2009 reflected a recessionary demand-side correction, with the Organization of Petroleum Exporting Countries cutting its share of the supply at the same time. The current problem is one of supply, with softened demand growth and OPEC adding production. While West Texas intermediate crude was below \$60 for less than six months in 2009, it’s already been below that level for the past nine months, with futures prices suggesting at least another year and a half below \$55, **Veritas** says.

Goldman Sachs made headlines Sept. 11 by suggesting oil could hit \$20 a barrel if the world gets into a situation of significant oversupply. Its “base case,” however, is a less-bearish but still pessimistic \$45 per barrel 12 months from now, down from \$60 previously.

“It is important to emphasize that as we now believe the market requires non-OPEC production to shift from our prior expectation of modest growth to large declines in 2016, the uncertainty on how and where that adjustment will take place has increased,” the Goldman analysts wrote. Investors had been focusing on the need for “high yield” U.S. exploration and production (E&P) companies – the ones with weaker balance sheets and non-investment-grade credit ratings – to “potentially be forced close to [bankruptcy](#).” Now, Goldman says, “the required magnitude of the U.S. production decline in 2016 now needs to include reductions by investment grade E&Ps, whose production is three times larger than high-yield E&Ps.”

As oil prices appeared to bottom in March, Citi says, more capital rushed into the energy industry via equity and credit issues. That “suggests investors may have been ‘calling the bottom’ of the market, and they certainly were not alone in that judgment. But fresh capital injections may only prolong the day of reckoning.”

In Canada, **Veritas** says, the brief period in 2009 that oil spent below \$60 “allowed investors to look past weak 2009 cash flows, while paying elevated cash flow multiples that reflected future prospects. The longer this downturn lasts, however, “the more likely it is that equities will sink to reflect next year’s low cash flows,” with a 25 per cent downside even if price-to-earnings multiples hold steady. A contraction of these multiples would bring “additional pain” to investors.

Here, then, is where investors with a contrarian streak and a tolerance for that kind of pain can speculate: **Veritas** says “if WTI rebounds to \$65-plus within two years and \$75-plus within four, then oil and gas equities are almost universally undervalued. If, however, long-run pricing for WTI falls to just \$65 plus inflation, then most names are overvalued.”

As part of the report, **Veritas** cut Canadian Natural Resources, Encana and PrairieSky Royalty to “sell,” but managed to maintain “buy” ratings on Canadian names “whose drilling economics and valuations thrive even at long-run pricing of \$65 for WTI oil and \$3.75 for NYMEX gas”: ARC Resources, Bonavista, Crescent Point, Enerplus and Vermilion.

In **Veritas'** view, however, none of the names on the buy list has a "fully supported" dividend at the 2016 oil futures pricing, "with all five likely to trim their payouts by year-end."

RBC's global energy team has run a downside pricing case with, among a number of oil and gas prices, a per-barrel price of \$40 for WTI in 2016.

Compared to their \$57 "base case" estimate, they estimate cash flow per share would drop an average of 25 per cent among integrated oil companies and 40 per cent to 45 per cent among E&P companies of varying sizes.

RBC also favours Canadian names with healthy balance sheets and strong past performance. Say they: "Our favourite integrated oil remains Suncor Energy, with Canadian Natural Resources our favourite producer. Cenovus Energy, Husky Energy, Enerplus Corp., and Vermilion Energy round out our Outperform roster."

Disclosure: The author owns Chevron Corp., Triangle Petroleum Corp., Whiting Petroleum Corp., Schlumberger Ltd., Transocean Ltd. and the SPDR S&P Oil & Gas ETF.