Energy: Sustainability Is Key

With the oil market in turmoil, it is an opportune time to share how SEAMARK manages investments within the energy complex. The strategy is in keeping with our overall equity strategy: identifying companies with competent management teams and conservative balance sheets, owning assets that can offer sustainable growth and attractive returns on invested capital.

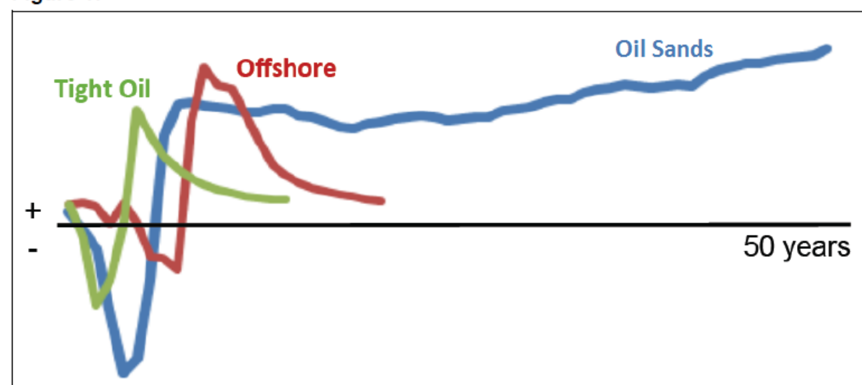
With oil prices averaging over $80 for the past 10 years, the energy sector has been an attractive space in which to invest. But not all investments are created equal. With the proliferation of horizontal drilling and hydraulic fracturing (fracking), the U.S.'s production has grown from 5 million bbl/d (barrels a day) in 2008 to 9 million bbl/d today. This is one of the benefits to the Saudis in their pursuit of a lower oil price strategy… they want North American production growth to slow so that they can maintain market share.

With that setting of the landscape, it is more important than ever to focus on the sustainability of growth and returns.

One would assume that this high growth in fracking production would be ripe for high returns, but we must look at these companies closer. The oil & gas that is getting surfaced in the U.S. Eagle Ford, Permian, Marcellus, Bakken and in Canada within plays like the Duvernay and Montney are not your grand-father's wells. These unconventional reservoirs have different production profiles than the oil coming from conventional, oil sands and deep water wells.

While the shale (or tight oil) plays are very popular with many fast investors, we have chosen to stay away from the trend. The reason is simple: very high decline rates pose risks to sustainable returns. Recent data suggests that declines in well production in North Dakota's Bakken play are between 40%[1] to over 50%[2] annually.

Figure 1: Illustrative Annual Cash Flow



In other words, production of these wells decline by almost half every year! Production typically peaks after the first few months of pumping. At the end of the day, in order to grow, these companies must continuously drill new wells, and that costs cash money. According to Tudor Pickering (a U.S. energy

[1] http://www.homerdixon.com/eia-shale-prod-stats/

[2] EIA Annual Energy Outlook 2013: http://www.eia.gov/forecasts/aeo/er/excel/yearbyyear.xlsx

brokerage firm), last year U.S. onshore producers spent $38 billion more than the $19 billion of cash flow they generated, compared with $1 billion of expenditure versus $18 billion of cash flow, a decade earlier.

Adding to the investment risk is the fact that many of these companies, especially the ones in Canada, have adopted aggressive dividend strategies. Not only do they need to convert oil into cash to pay for the drilling of new wells, they are also attempting to juggle a dividend. In normal markets, when cash hasn't come in quick enough, these companies have tapped the debt and equity markets for new sources of cash, therefore increasing financial risk and diluting existing shareholder's equity. With today's oil prices, these companies will have a hard time raising new funds.

We've already observed in the past month several of these Canadian companies cut or suspend its dividends, including but not limited to: Baytex Energy, Bonavista Energy, Trilogy Energy, Lightstream Resources, Journey Energy (IPO'd in June 2014) as well as Penn West Energy, which recently announced a second cut to its dividend within the last 18 months.

SEAMARK loves dividends, but we do not let what looks like attractive yields seduce us into investing in unsustainable/risky ventures. That is the old trap of stretching for yield. Our approach has therefore led us to investing in integrated oil sands plays, energy services companies, and pipelines.

The extraction of bitumen from the oil sands has a much different cash flow profile (see Figure 1 above). The upfront costs are high, but once it has been invested, the maintenance investments that need to be made to keep production up, are minimal by comparison. In fact, the breakeven costs for oil sands projects that are already up and running can be as low as $10 to $20/bbl. This business model converts itself to high reoccurring free cash flows. Once the investment is made, production and cash flow will be sustained for decades to come.

Many of the oil sands companies are integrated companies, meaning that they own the entire value chain. For example, Suncor owns the oil sands mines, the upgraders and refineries as well as the gas stations themselves (i.e. PetroCanada). Being integrated allows companies to capture the entire value within the chain, but also lowers volatility in cash flows. As prices increase, the company makes more money from its oil production, but when prices decline, refineries and gas stations actually have higher margins. Being integrated also allows for the closing of the gap between different markets for oil. For example, as of the date of this writing, a barrel of Canadian oil is only worth USD $38 versus the USD $53 that a barrel would fetch in the U.S. and USD $57 in Europe. Being integrated allows these companies to realize prices closer to the international benchmark (i.e. Brent Crude traded in London).

This long-term oriented strategy has allowed SEAMARK to outperform the energy sector handsomely in this year of collapsing oil prices. In fact, if you look at this past quarter where the oil price has declined to $53 from $91 at the beginning of October, a 42% decline in a short 3 months, our Canadian Equity Pooled Fund's energy segment has declined 8.6% versus the S&P/TSX Energy Index declining 15.8%.

Outperforming by taking the long term view is consistent with other risk-averse investment strategies we incorporate in portfolios.

Joel Muise, CFA | Investment Analyst