



Insigneo Weekly Dispatch

# Is Energy Still the Proverbial Skinny Cow?

- Is the Energy sector still a good investment?
- What are the oil market's supply and demand dynamics?

## Is Energy Still the Proverbial Skinny Cow?

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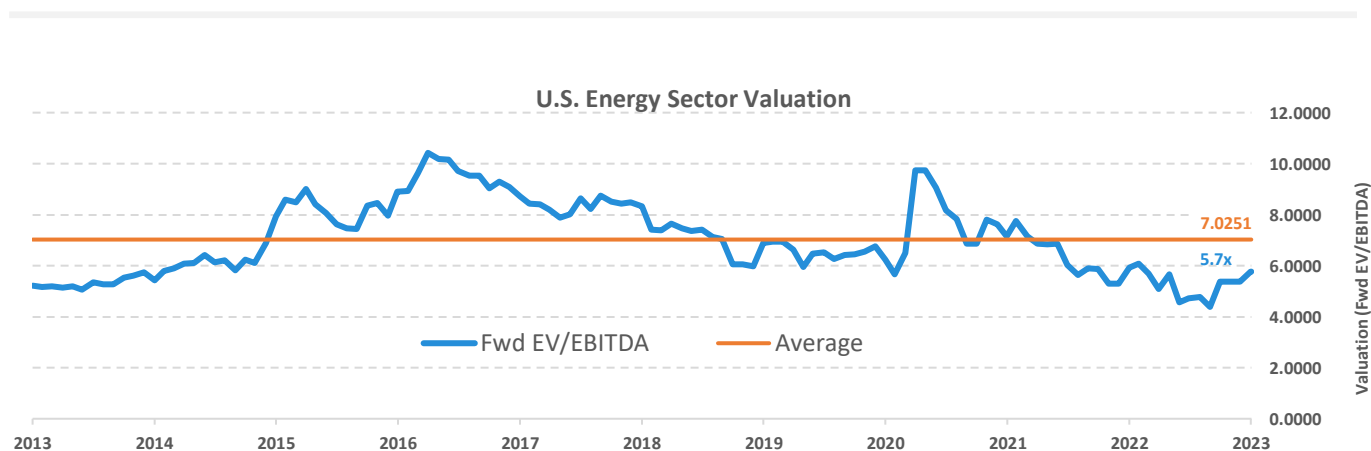
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When asked about his investment philosophy, Carlos Slim once famously replied: “I like to buy a cow when it’s skinny and sell it when it’s fat.”. This philosophy makes perfect logical sense: we buy what we perceive to be an attractive asset when it is inexpensive and sell it at a higher price. But how many of us actually follow this philosophy? It is easier said than done. It is not hard to get sidetracked by a seemingly more attractive option, regardless of its relative value. This is where a disciplined investment process pays off.

**Based on this process, we believe that certain sectors of the equity markets look more**

**attractive than others at this point in the economic cycle. One of these sectors is Energy.**

Although P/E is a widely accepted valuation measure, companies in capital intensive sectors such as Energy, Materials, and Industrials are best evaluated through the lens of the EV/EBITDA ratio. As a refresher, this ratio basically represents a company’s value in relation to its profits from operations. Using the Energy Select Sector SPDR ETF (XLE) as a proxy for the U.S. Energy market, as well as Bloomberg’s estimates of the ETF’s EV/EBITDA ratio for the year ahead, we can appreciate the sector’s valuation in the chart below. As we can see on the chart, as of the end of January and despite its outperformance last year, the Energy sector is trading at an EV/EBITDA of 5.7x, more than 20% below its 10-year average valuation of 7x. The sector’s historical valuation discount has begun to narrow, and we believe that it will continue to revert back to its mean over time. There are several reasons for this, but none are more important than favorable supply and demand dynamics.



Supply is the most important factor in our thesis, as it is likely to remain constrained for the foreseeable future. An increased focus by producers on capital discipline, underinvestment in production resources, and political pressures are likely to keep production growth muted. Additionally, sanctions on Russian oil and a push to keep the same capped at \$60/barrel could further affect global supply. At the same time, OPEC is incentivized to keep a floor on Brent oil prices near the \$90/bbl level. In fact, OPEC chose to leave production unchanged after a meeting this past Wednesday. Even if producers like Saudi Arabia consider increasing production, the reality is that spare capacity in most of OPEC's member countries remains limited. Out of the approximately 5.3 million barrels of spare capacity currently in OPEC, only 30% of this is held by Saudi Arabia. The second largest amount, 25%, is in Iran followed by the UAE at 20% and Nigeria at 9%. As we have seen in the past, Iran is willing to weaponize oil to suit its geopolitical ambitions, adding more uncertainty to global supply. It is also important to note that the United States has become the largest oil producer in the world. However, in response to political, environmental, and shareholder pressures, the country's oil producers have shifted from a drill-first mentality to a strategy of capacity rationalization. This has created a severe underinvestment in the industry's production resources, a reality recently stressed by Exxon Mobil's CEO during the company's most recent quarterly call.

The demand for oil presents a more varied set of possible outcomes. On one hand, concerns over higher interest rates and their impact on global growth could pose headwinds to increased oil demand. Fears over global recession could lead consumers to use less of the commodity, putting Energy companies in the United States, and many around the world, are now focused on cash flow generation, not just profit growth. Financial

pressure on prices. On the other hand, the reopening of the Chinese economy after the end of Covid-lockdowns could release pent-up demand in the country. Increased demand, particularly for travel, could drive oil prices higher.

As of February 1<sup>st</sup> of the current year, oil prices stood at \$76.70/bbl of WTI oil and \$83.03/bbl of Brent oil. WTI, or West Texas Intermediate oil is used to quote prices in the United States, while Brent Sea oil is used to quote prices internationally. Barring any major geopolitical disruptions, J.P. Morgan foresees Brent prices moving higher, closing this year at \$94/bbl. However, oil prices have retreated from previous highs seen at the end of last year and could come down further in the first half of this year if demand proves to be lower than supply as recession fears remain.

Most companies in the Energy sector are going to start reporting fourth quarter 2022 earnings over the next few weeks. We have already seen Exxon Mobil (XOM) and Chevron (CVX) report earnings over the past week. Although both reported record profits last year, their earnings' outlooks for 2023, although still incredibly robust, are expected to be lower than in 2022. This is mostly due to the expectation of still elevated, yet lower oil prices compared to the highs seen last year. This dynamic could even put temporary pressure on stock prices in this sector.

discipline and the responsible use of capital are now the emphasis. As a result, balance sheets are in stronger positions than in the past, being able to

return cash flows to shareholders in the form of dividends and stock buybacks. In addition to being in attractive financial positions, these companies are also facing attractive supply/demand prospects in the oil market, which should lead to elevated oil prices, further strengthening their coffers. However, keeping in mind the chart on the previous page, we can see that valuations for the sector are still historically low. **So, if we think about it, we are being presented with attractive assets, with reasonable growth potential, trading at discounted valuations.** We believe that Energy is still the proverbial skinny cow and would add exposure to the sector, especially if stock prices come down as a result of earnings in the near term.

For actionable ideas on how to gain exposure to the sector, please contact the Insigneo Research Team.



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