A Dive into the Energy Sector: Part 2

– Danke Wang, Portfolio Manager

In part 1 of our dive into the Energy sector, we emphasized that by screening for energy stocks with a high free cash flow (FCF) yield, we can identify where high FCF is generated and where such profitability is undervalued. Now, we'll take a closer look at these value opportunities within the sector.

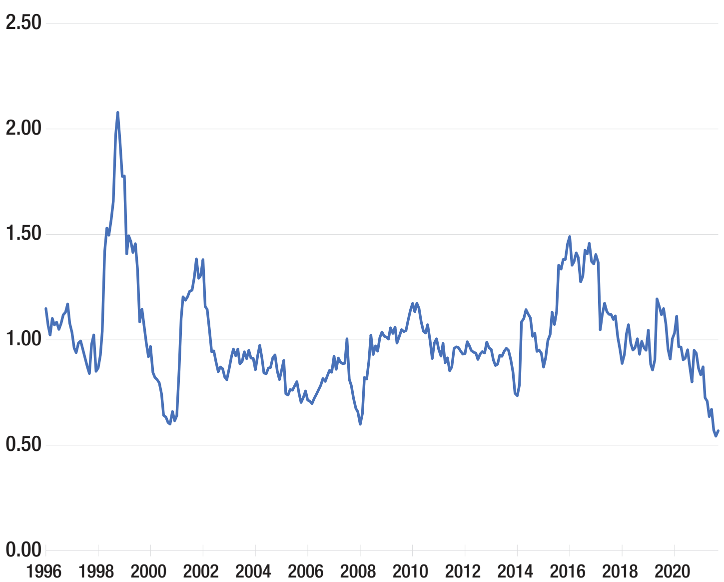
Key Takeaways

1. The valuation level of the Energy sector indicates that investors have deemed near-term FCF unsustainable.
2. Despite pending recession risk, the supply-demand of oil and fundamentals in the Energy sector might tell a different story.
3. The high FCF yield on both a trailing and forward basis give us confidence on a potential value opportunity to bet on.

The Energy sector is the cheapest sector in the market right now. As of 8/31/2022 the sector is trading at half of the market's forward multiple, a record low.

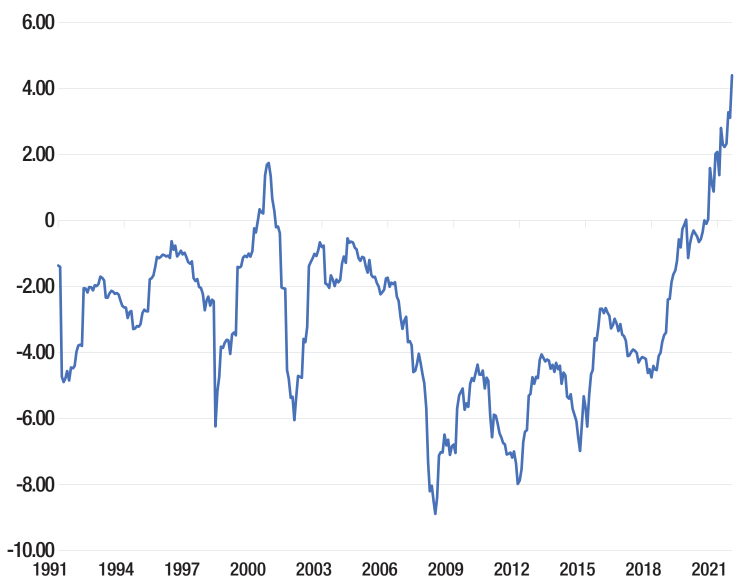
The relative FCF yield of the Energy sector, based on trailing 12-month data, is at the highest level since 1990.

S&P 900 Energy Stocks Relative Average Foward P/E
12/31/1996 - 8/31/2022



Source: FactSet

S&P 900 Energy Stocks Relative Average FCF Yield
12/31/1991 - 8/31/2022



Source: FactSet

Currently, more than 50% of the energy companies in the S&P 900 are among the top 100 FCF yield companies, all of which are from the oil, gas and consumable fuels industry. Five years ago, that number was only 12%, most of which were energy equipment & services companies.

There are a lot of reasons that may explain the record low valuation. But one thing we are sure of is that there is a value gap between the sector's high near-term profitability and market skepticism.

Skepticism in the Energy Sector

The Energy sector is influenced by supply and demand. Historically, there have been multiple episodes of significant oil price fluctuations.

For example, in the 1973 oil crisis (with the background of the cumulative effects of dollar devaluation, unanticipated US inflation, and high oil demand fueled by strong economic growth) a negative shock to the supply of crude oil caused a 300% spike in oil prices. In the early 1980s, a systematic decline in oil prices was triggered by lower demand from a global recession, along with increased oil production in non-OPEC countries.

In 2022, after reaching the highest level in a decade, oil prices pulled back from around the $120 mark to around the $80 mark per barrel, reflecting the market's concern about oil demand destruction. As a result, Energy stocks dropped by more than 26% from 6/8/2022 to 7/14/2022, falling into a bear market.

Historically, oil demand collapses are primarily associated with the most severe economic contractions, such as the 2008 crisis and the 2020 COVID outbreak. This time, investors' lack of confidence is justified to some degree, particularly under the backdrop of a potential global recession driven by surging energy prices, rapid inflation, and the Fed's stance of prioritizing price stability. On top of that, the expectation of energy transition away from fossil fuels also powered the "end of oil" sentiment. Ultimately, there is skepticism in the market about whether the recent high levels of profitability and FCF from the Energy sector are sustainable.

Conversely, several things suggest there is a case for investing in the Energy sector.

Optimism in the Energy Sector

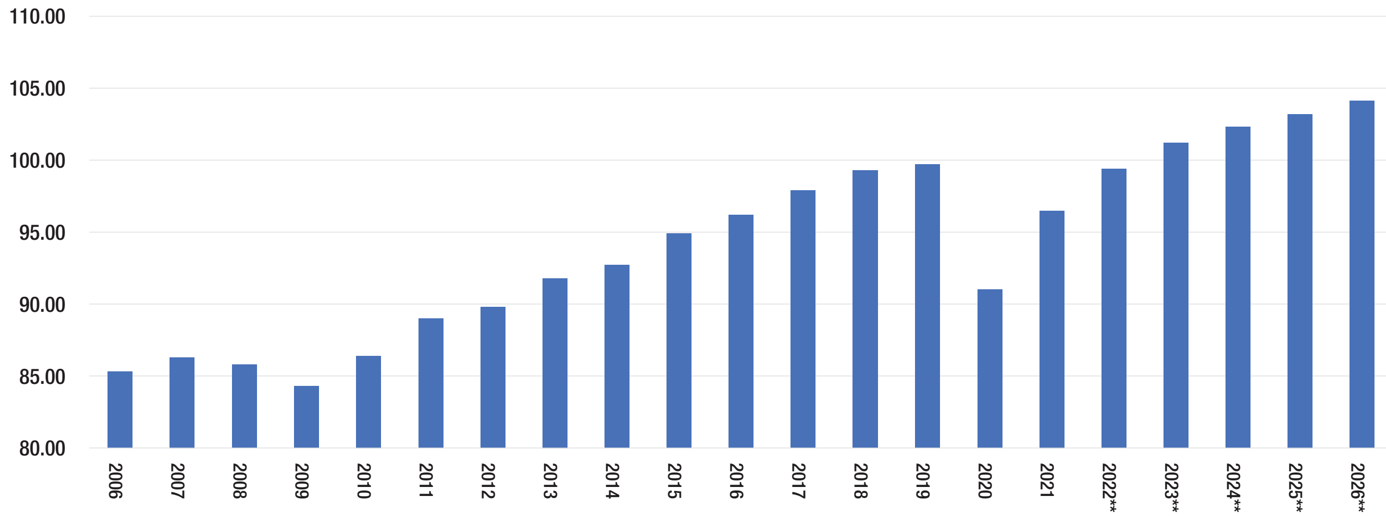
Demand

Global oil demand is pointing higher from now to next year.

- From the IEA August 2022 oil market report: "world oil demand is now forecast at 99.7 mb/d in 2022 and 101.8 mb/d in 2023", surpassing pre-Covid levels, they also added "soaring oil use for power generation and gas-to-oil switching are boosting demand."[1]
- In September, the EIA forecast "that global consumption will rise by an average of 2.1 million b/d for all of 2022 and by an average of 2.0 million b/d in 2023." More specifically, it increased its forecast for the end of this year and beginning of next year, stating, "in 4Q22 and 1Q23… electricity providers, particularly in Europe, may switch to oil-based generating fuels."[2]
- From OPEC, "better-than-expected containment of COVID-19 and expected firm global economic growth are projected to support global oil demand in 2023, which is forecast to grow by 2.7 mb/d" to average 103.0 mb/d, mostly in China and India.[3]

(1) https://www.iea.org/reports/oil-market-report-august-2022
(2)https://www.eia.gov/outlooks/steo/
(3) https://www.opec.org/opec_web/static_files_project/media/downloads/publications/OPEC_MOMR_July-2022_Revised.pdf

Daily Global Crude Oil Demand
2006 - 2026



Source: IEA, Statista **Estimated

Additionally, according to Bloomberg, not all recessions lead to demand crashes. Milder US recessions such as 1990/1991 and 2001 are contemporary examples; in both cases, oil demand growth slowed down, but there were no contractions. The 1990/1991 market environment was similar to what we see today, with rising interest rates, high oil prices, soaring inflation, and a war. If the next recession resembles 1990-1991 or 2001, oil demand may be weakened, but it could still see annual growth.[1]

At the same time, we should distinguish between financial and physical demand for oil. The financial demand is related to the trading of crude oil as an investment asset class or a hedge for risk, which is not energy specific. This demand is 30 times larger than the global physical oil demand. Recent oil price selloffs may have reflected weak financial demand for oil instead of physical demand, i.e., the fundamentals.

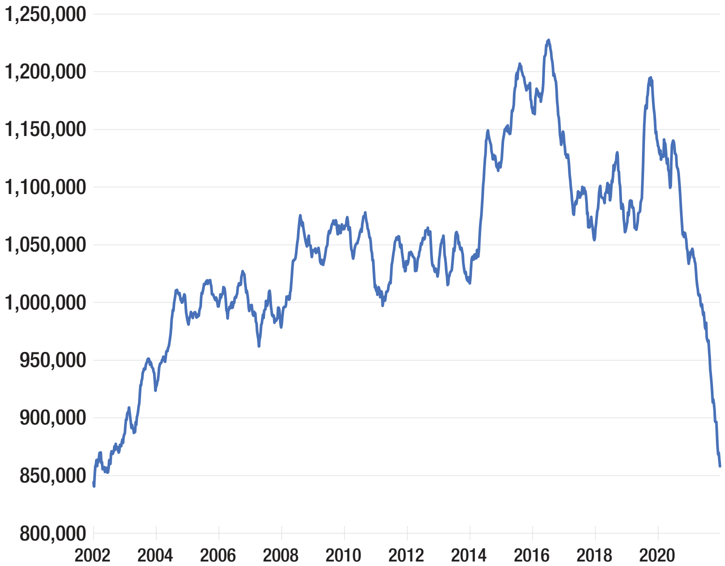
Supply
Though an economic slowdown or recession might lead to lower oil demand growth, the price of oil is not just dictated by demand but also by supply.

- The EIA September report forecast the Brent crude oil spot price to average $98 per barrel in the fourth quarter of 2022 (4Q22) and $97 per barrel in 2023, citing "the possibility of petroleum supply disruptions and slower-than-expected crude oil production growth continues to create the potential for higher oil prices."[2]
- In the June report, the IEA highlighted that "global oil supply may struggle to keep pace with demand next year, as tighter sanctions force Russia to shut in more wells and a number of producers bump up against capacity constraints."[3]

Inventory is a key component to the supply side of this equation. Despite the (unsustainable) release of the strategic petroleum reserve (SPR) for temporary supply, global inventory continues to fall, indicating an undersupplied market. In fact, the inventory has been eroded since the middle of 2020, leaving the market vulnerable to shocks arising from strong consumption, which is why oil prices shot to such high levels this year. US crude oil stocks, including the strategic petroleum reserve, have depleted to the lowest level since 2008.

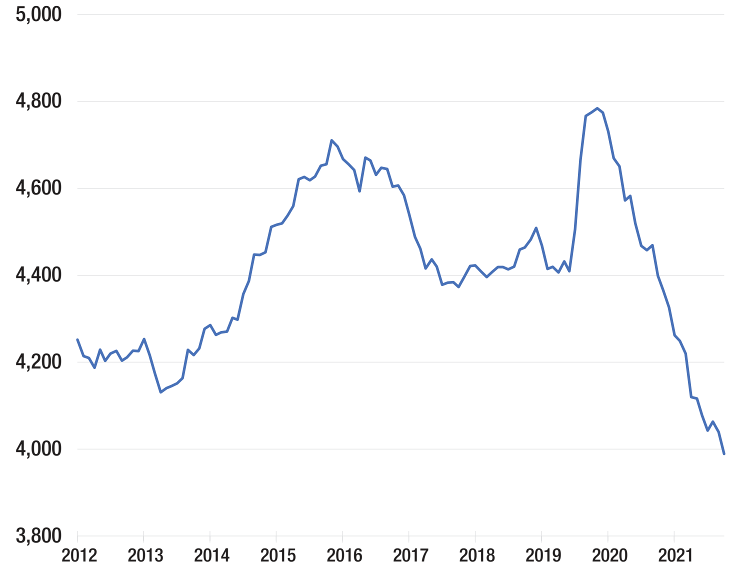
(1)https://www.bloomberg.com/opinion/articles/2022-05-17/is-the-u-s-headed-for-recession-oil-market-needn-t-fear-a-calamitous-slowdown?sref=fBP8AbSM
(2)https://www.eia.gov/outlooks/steo/
(3)https://www.iea.org/reports/oil-market-report-june-2022

Crude Oil Stocks, Including Strategic Petroleum Reserves (SPR), Thous Barrels - U.S. as of 9/16/2022



Source: FactSet

Petroleum and Other Liquids Stocks, Mil Barrels - OECD Total as of 6/30/2022



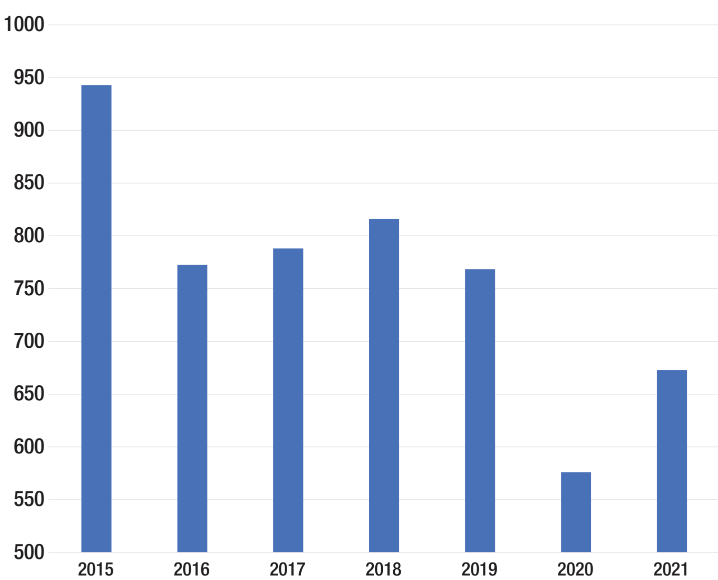
Source: FactSet

Furthermore, we are facing a market with cyclical underinvestment. US shale growth, which has supplied most of the increase in global crude production between 2010 to 2019, is constrained because investors do not want to pursue growth. Instead, they demand a return of capital (share buybacks and dividends), so companies are restricted on how much they can spend (or those companies opt to limit growth). Though production is picking up through higher capital spending, many firms may continue to commit to the capital discipline we mentioned in [part 1 of this series](#).

Without sufficient investment, a lack of global spare capacity in oil production and refining will make it difficult for oil and gas to meet supply needs, which may lead to greater market volatility and higher prices.

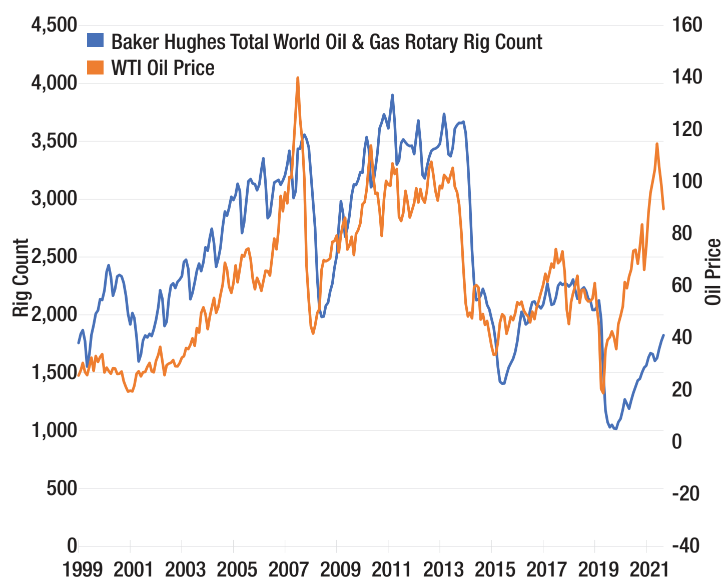
Physical oil markets have rarely looked tighter.

World Investment on Oil and Gas Supply



Source: IEA

World Rig Count vs. Oil Price
as of 8/31/2022



Source: Bloomberg

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. YOU CANNOT INVEST IN AN INDEX.

Breakeven Oil Price

Outside of the aforementioned macro-economic factors, oil companies have improved their businesses in recent years.

US oil and gas companies can profitably drill oil at a price as low as $40 (breakeven price), unlike what we saw 10 years ago. So, despite the crude oil future price curve being inverted (indicating the market's expectation of a lower price in the long term), oil companies can generate enough cash flow to cover capital expenditures and dividends.

Source: FactSet

U.S. Oil and Gas Industry Trailing 24 Month Average Breakeven Oil Price as of 3/31/2022

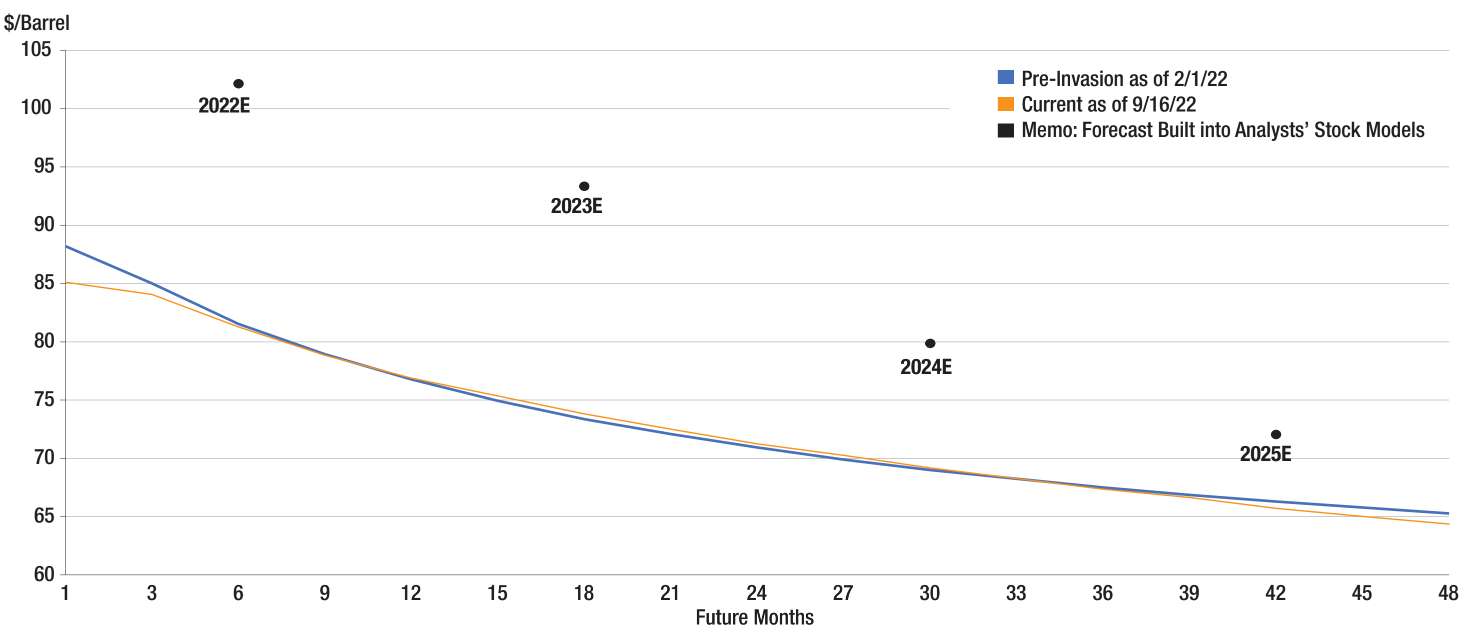
Oil price discounted in stock price

An oil price estimate is essential to the valuation model when equity research analysts set price targets for energy stocks. Currently, the average oil price assumptions are above the levels built into the futures market. For example, the consensus estimates for 2024 West Texas Intermediate's (WTI) price among equity analysts is around $80 per barrel, while the oil futures contract for 2024 is traded at about $70 (as of mid-September), reflecting the market's pessimism on oil prices (mainly due to recession concerns).

At the same time, such sentiment is demonstrated in current energy stock prices (most oil stocks are discounting WTI oil prices below $70 over the long run). Therefore, oil stocks provide investors with an intriguing opportunity to take advantage of the value gap, explained by the polarized point of view on the future commodity prices.

This is also why the Energy sector's FCF yield is so high on a trailing 12-month (LTM) and forward-looking basis.

WTI Oil Futures Curve



Source: Empirical Research Partners Analysis

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High FCF Yield

In addition to a high trailing 12 months FCF Yield, oil companies trade at a large forward FCF yield despite built-in lower future oil prices. Assuming those oil and gas companies maintain strong FCF generation, such a high forward FCF yield means those companies can buy back shares and pay down debt in less than 10 years.

S&P 500 Oil & Gas Companies
as of 8/31/2022

		LTM FCF Yield	FCF Yield FY 2022	FCF Yield FY 2023	FCF Yield FY 2024
Marathon Oil Corporation	OIL & GAS EXPLORATION & PRODUCTION	16.45	21.63	16.76	13.17
APA Corp.	OIL & GAS EXPLORATION & PRODUCTION	16.05	16.54	13.33	11.14
Diamondback Energy, Inc.	OIL & GAS EXPLORATION & PRODUCTION	11.88	14.30	11.91	9.41
Occidental Petroleum Corporation	INTEGRATED OIL & GAS	11.65	13.87	10.39	7.76
Exxon Mobil Corporation	INTEGRATED OIL & GAS	11.37	12.41	9.32	7.95
Devon Energy Corporation	OIL & GAS EXPLORATION & PRODUCTION	11.16	13.25	12.47	10.13
ConocoPhillips	OIL & GAS EXPLORATION & PRODUCTION	10.59	13.74	11.18	9.91
Pioneer Natural Resources Company	OIL & GAS EXPLORATION & PRODUCTION	9.75	13.99	9.92	8.06
Chevron Corporation	INTEGRATED OIL & GAS	9.73	11.29	10.33	9.08
Coterra Energy Inc.	OIL & GAS EXPLORATION & PRODUCTION	8.16	14.69	12.26	10.11
EOG Resources, Inc.	OIL & GAS EXPLORATION & PRODUCTION	5.31	10.97	10.79	9.78
Hess Corporation	OIL & GAS EXPLORATION & PRODUCTION	1.45	4.62	5.37	4.91
	Average	10.30	13.44	11.17	9.28

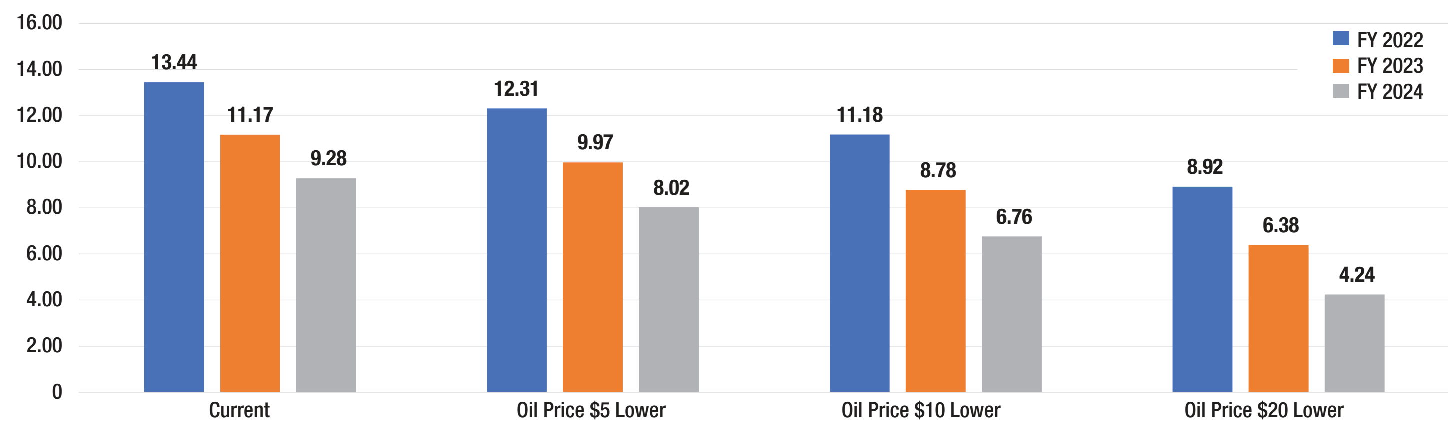
Source: FactSet. LTM – last twelve months.

But what if the equity analysts are wrong? What if the oil price ends up trading at the level indicated by the futures curve?

We simulated scenarios assuming oil prices are \$5, \$10, and \$20 lower than what equity analysts forecast and measured the corresponding forward FCF yield.[1]

So even if future oil prices drop, US oil companies on average still hypothetically generate relatively large FCF yield compared to the S&P 500's average, which trade around 3%.

Average Forward FCF Yield based on Different Future Prices
as of 8/31/2022



Source: FactSet, Pacer Advisors

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The Pacer US Cash Cows 100 ETF (COWZ) invests in the top 100 highest free cash flow yielding companies within the Russell 1000. The portfolio has more than 25% weight in the Energy sector as of 9/30/22, making it the top exposure. Such overweighting reflects where free cash flow is generated in the market and where such profitability is undervalued. Among the energy companies, the majority of them are oil and gas producers. Despite the market's dispersed view of the Energy sector, the high FCF yield level gives us good reasons to bet on it.

PACER US CASH COWS 100 ETF

COWZ

Pacer US Cash Cows 100 ETF

Is a strategy driven exchange traded fund that aims to provide capital appreciation over time by screening the Russell 1000 for the top 100 companies based on free cash flow yield.

[(1)] *Methodology:*

This calculation is simplified by assuming the change of future FCF will be based on oil price changes multiplied by future oil production estimates adjusted by tax rate.

Taking 2023 as an example:

$$\frac{\text{FCF Estimate FY 2023-Annualized Daily Oil Production} \times \text{Price Change} \times (1\text{-Tax Rate})}{\text{EV}}$$

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The Pacer US Cash Cows 100 Index was released on 12/8/16.
Free Cash Flow (FCF): A company's cash flow from operations minus capital expenditures (expenses, interest, taxes, and longterm investments)
Enterprise Value (EV): A company's market capitalization adjusted to eliminate any capital structure bias (i.e. by adding debt and subtracting cash or cash equivalents)
Free Cash Flow Yield (FCF/EV): Measures a company's total free cash flow relative to its enterprise value. This is an internal statistic and does not constitute investor yield.
Forward P/E: Market Price per Share / next 12 month earnings per share
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