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PALOS

Weekly Commentary

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*By Charles Marleau CIM® and William Mitchell CIM®*

# The Oil Patch Continues to Pump Out Cash

Last week, we looked at the mixed bag of earnings reports from mega-cap technology stocks. This week, we return north of the border to catch up on Canada's largest oil and gas companies who reported results between October 28 - November 3.

The trials and tribulations of the fossil fuel industry are well documented. In recent years, pressure from climate interests, politicos and plummeting prices for crude provided a significant headwind for growth. As a means of survival, many companies reigned in capital expenditures and prioritized protecting the balance sheet over spending to grow future production. Who can blame them? Fast forward to today's reality where the Ukraine-Russia conflict has disrupted global energy markets by driving European gas prices through the roof.

**Imperial Oil (TSX/NYSE: IMO)** was first to report on October 28. For Q3/2022, IMO reported earnings of just over $2 billion with cash from operating activities totalling almost $3.1 billion. Performance was attributed to strong fundamentals and downstream operational performance which included a fifth consecutive quarter of refinery utilization. Proceeds from Imperial's sale of its interest in XTO Energy was used to reduce debt and the excess cash returns were used to return $227 million in dividends to shareholders. Further enhancing shareholder returns, the company completed its normal course issuer bid (NCIB) ahead of schedule. NCIB's, which are commonly referred to as share buybacks, occur when companies repurchase shares in the open markets. NCIB's enhance returns by reducing the number of shares outstanding.

Further, IMO announced a 29% increase in its quarterly dividend, the largest increase in company history. On October 31 the company announced its intention to initiate a Significant Issuer Bid (SIB) which would equate to a $1.5 billion return to shareholders in Q4. SIBs, which are conducted by way of "Dutch Auction", occur pursuant to an issuer's stated intention to repurchase for cancellation a specific number of shares within a predetermined price range. SIBs, simply put, are an efficient way to distribute cash to shareholders. The SIB, which will remain open from November 4 to December 9, offers to repurchase up to $1.5 billion with a tender price range between $72.50 to $87.00 per share.

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**Suncor (TSX/NYSE: SU)**, Canada's second largest producer by market capitalization ($65 billion), released Q3 earnings on November 2 with $4.5 billion in adjusted funds from operations, the second highest in company history. As part of its capital distribution strategy, SU returned approximately $1.7 billion of value to shareholders through $1.0 billion in share buybacks and $638 million in dividend payments. Through the first 10 months of this year Suncor has repurchased approximately $4.6 billion (7.3%) of its outstanding common shares and reduced net debt by roughly $1.87 billion.

**Cenovus Energy (TSX/NYSE: CVE)** also announced on November 2 with adjusted funds flow near $3 billion and free funds flow of $2.1 billion. As per CVE's shareholder return policy, approximately half of excess free funds flow were used to return cash to shareholders through buybacks which totalled about $660 million in Q3. The current buyback program expires this month and a subsequent NCIB has been approved by the Board. When including dividends, CVE has returned approximately $2.9 billion to shareholder through the first three quarters.

**Canadian Natural Resources (TSX/NYSE: CNQ)** closed out the earnings window for the "Big Four" on November 3. For Q3/2022, CNQ saw record quarterly production across all assets including record natural gas production. As announced by CFO Mark Stainthorpe during the earnings call, returns to shareholders remained significant throughout 2022 with approximately $10 billion returned through dividends ($4.9 billion) and buybacks ($5.0 billion). The Board has approved a 13% increase in the quarterly dividend – the second dividend bump this year. Remarkably, through thick and thin CNQ has successfully extended its track record of yearly dividend increases to 23 consecutive years. The dividend has "doubled" since the beginning of 2021, not including a special dividend of $1.50 per share that was paid during Q3.

Canada's massive oil assets, a vast majority of which lie in Alberta's oil sands rank only behind Venezuela, Saudi Arabia and Iran in terms of proven reserves. In terms of production, Canada supplies roughly 4.5 million barrels per day (MMb/d), accounting for 6% of world production, ranking fourth behind the United States (17%), Saudi Arabia (12%) and Russia (12%). The petroleum industry directly contributes $18 billion to Nominal GDP (3.9%) and provides 178,500 jobs (source: Natural Resources Canada 2021-22 Energy Fact Handbook). As the supply side of the energy equation continues to shrink, global demand for energy is destined to grow well into the future and energy companies should benefit over the long term.

Robust profits from Canada's oil patch are not limited to its shareholders. Increased royalties and taxes paid to provincial and federal governments contribute significantly to GDP, employment, national energy security, social programs and local communities. These benefits are often overlooked by critics who focus solely on issues related to the environment. Another criterion that favorably distinguishes Canadian producers from those operating in foreign jurisdictions is the Pathways Alliance (pathwaysalliance.ca), a partnership initiative created by Canada's largest oil sands producers to achieve Canada's zero net greenhouse gas emissions target by 2050. Yet another reason to be bullish on Canadian energy.

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| Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1] | FundServ | NAVPS | YTD Returns |
|---|---|---|---|
| Palos Income Fund L.P. | PAL100 | $8.33 | -8.69% |
| Palos Equity Income Fund - RRSP | PAL101 | $6.48 | -9.40% |
| Palos WP Growth Fund - RRSP | PAL213 | $12.29 | -31.07% |
| Palos-Mitchell Alpha Fund [3] | PAL300 | $8.43 | -16.27% |
| S&P TSX Composite (Total Return with dividends reinvested) | | | -5.99% |
| S&P 500 (Total Return with dividends reinvested) | | | -19.85% |
| S&P TSX Venture (Total Return with dividends reinvested) | | | -36.73% |
| **Chart 2: Market Data [1]** | | | **Value** |
| US Government 10-Year | | | 4.16% |
| Canadian Government 10-Year | | | 3.50% |
| Crude Oil Spot | | | US $92.61 |
| Gold Spot | | | US $1,676.60 |
| US Gov't10-Year/Moody BAA Corp. Spread | | | 218 bps |
| USD/CAD Exchange Rate Spot | | | US $0.7419 |

[1] *Period ending November 4th, 2022. Data extracted from Bloomberg*

[2] *Fund is priced annually*

[3] *Fund is priced weekly on Tuesdays*

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