Will Investors See More Volatility in the Energy Patch?

Description

There is a growing chorus of industry insiders who are cautioning investors that there is worse yet to come for the price of oil and Canada's energy patch. This now sees them warning investors to expect even more volatility, with low crude prices set to be part of the energy landscape for the foreseeable future.

So what?

There are a number of signs that crude prices are set to remain depressed for some time and could even fall below the five-and-a-half-year lows touched in January this year.

The volume of crude stored in the U.S. has hit record levels with 418 million barrels stored.

Despite North American oil producers slashing capital budgets and shuttering in rigs, oil production continues to grow. Since July last year when the rout in crude began, oil and other crude liquids production has surged by 3% and is expected to continue growing. This can be attributed to many operators shutting down marginal rigs, while highly productive rigs continue to operate.

Investors should also note that rapid advances in drilling technology in recent years, including horizontal drilling and hydraulic fracturing, have increased the efficiency of many rigs. The rout in oil has also seen producers focus on using rigs for oil production rather than speculative and costly exploration, further causing production to rise.

The International Energy Agency (IEA) has forecast that global inventories of crude will continue to grow before cuts in capital investment in the industry have any impact on production volumes.

Clearly, the global supply glut for oil can only get worse, putting further pressure on crude prices. This has seen some industry insiders predict that oil prices could fall to as low as US$30 per barrel before there are any signs of a recovery.

If this were to occur it would certainly have a severe impact on a number of companies in Canada's energy patch, triggering a further slide in share prices and analyst downgrades.

Now what?

Investors need to do their homework before investing in the patch. They should focus on companies with solid fundamentals that are capable of weathering lower crude prices. They should avoid those companies with weak balance sheets that are highly levered like **Lightstream Resources Ltd.**, **Penn West Petroleum Ltd.**, and **Pengrowth Energy Corp.**

However, even if oil prices fell further there are two companies in the patch that still have solid growth prospects. These are midstream services and transportation providers **Enbridge Inc.** (TSX:ENB)(NYSE:ENB) and **TransCanada Corp.** (TSX:TRP)(NYSE:TRP).

Both form an integral link between oil and gas producers in the patch and crucial energy markets. This effectively allows them to collect a toll on every barrel of crude and cubic meter of gas they transport. It also means they have relatively stable earnings and, when combined with the steep barriers of entry associated with the midstream industry, they can easily maintain their competitive advantage.

Even more promising is that despite softer crude prices, Canadian crude production is expected to grow over the long-term, further boosting their earnings and enabling them to continue rewarding investors with steadily growing dividends.

Since commencing dividend payments in 1953, Enbridge's dividend has a compound annual growth rate of 11%, giving it a sustainable yield of 3%. TransCanada's dividend has a compound annual growth rate of 6% since commencing payments in 2001, giving it a sustainable yield of 3.3%.

Clearly, fears of a further slump in crude prices will drive additional volatility in the patch and while I am bullish on the prospects of crude over the long term, perhaps now is the time to avoid pure oil or upstream producers.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

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2. NYSE:TRP (Tc Energy)
3. TSX:ENB (Enbridge Inc.)
4. TSX:TRP (TC Energy Corporation)

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