3 Things Every Energy Investor Needs to Look for

Description

Despite the fact that the overall TSX energy sector has lost 23% in the past six months, there is good news for energy investors. Even though the energy sector as a whole saw significant declines, there is plenty of variation in performance between individual energy companies.

As a simple example, during the worst of the decline integrated producers fell 18% compared to 38% for non-integrated exploration and production names. Similarly, if you look at a long-term period over the past five years, there is even more variation in returns, with some names consistently outperforming.

There are three major factors that the strongest performing energy companies in good times and bad usually possess, and by checking these before making a purchase, your odds of a successful investment increase dramatically.

1) Plenty of free cash flow

Free cash flow is not only one of the most important indicators of a business's health, but it is also a major predictor of future returns. Ultimately, the purpose of a business is to generate cash, and no indicator measures this better than free cash flow.

Measures like earnings, or earnings before income taxes, depreciation and amortization (EBITDA) are poor indicators of cash generation, since earnings incorporate plenty of non-cash expenses and revenues (such as depreciation or accounts receivable). EBITDA does include the hugely important capital expenditures expense.

Free cash flow takes the cash a business generates from its operations, subtracts the capital expenditures necessary to maintain and grow production, and what remains is cash that can be used to pay dividends, buy back shares, fund new growth projects, pay down debt, or simply provide a cash cushion for an energy company in the event of falling oil prices and cash flows.

As a result, it has been found that free cash flow is strongly correlated with returns for oil and gas companies. Analysts at **TD Bank** found that the companies with the highest free cash flow had the best returns over the past five years.

Suncor Energy Inc. (TSX:SU)(NYSE:SU) and **Canadian Natural Resources Ltd.** (TSX:CNQ)(NYSE:CNQ) both have industry leading free cash flow, and as a result, Suncor and Canadian Natural Resources were ranked number one and number three, respectively, for total returns over the past three years out of their peer group.

2) Low debt

Like free cash flow, low debt provides a company with high flexibility in all price environments. Companies with high debt, for example, will have higher interest payments, which in turn, reduces cash flow. In a period of weak pricing, these companies will need to make difficult choices, such as cutting growth capital expenditures or reducing dividends in order to maintain interest payments.

These companies also have less flexibility to cut drilling expenses, since increased production levels may be required in order to maintain interest payments. The result is these companies are in much worse shape in a weak pricing environment.

The evidence confirms this, and for the three months ending in December 2014, the companies with the lowest share price declines were also the companies with the lowest debt. Once again, Suncor and Canadian Natural Resources had the lowest declines among their peer groups (declining 26% and 28%, respectively, during the worst three months), and this is due to the fact they also have some of the lowest debt, with Suncor having the lowest debt.

3) Solid dividends and share buybacks

Dividend growth and share buybacks are made possible by solid free cash flow and low debt, and they can serve to reduce share price volatility in weak pricing environments and increase total returns in all price environments.

Companies with strong programs that reward shareholders are less likely to lose shareholders and more likely to gain shareholders from weaker players during volatile periods, which supports shares. In addition, strong dividends and buybacks work to reduce losses in weak periods and bolster gains in strong periods.

It should serve as no surprise then, that Suncor and Canadian Natural Resources are, once again, leaders in both these areas, which contributes to their outperformance.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:CNQ (Canadian Natural Resources)
2. NYSE:SU (Suncor Energy Inc.)
3. TSX:CNQ (Canadian Natural Resources Limited)

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