Buy Energy Companies for Their Risk/Reward Attributes

Description

Energy has long been one of the backbones of the Canadian economy. Since reaching a peak in 2011, the price of oil crashed and has only recently begun to stabilize. The resulting crash has thrown valuations into disarray, and the TSX is home to some of the most undervalued companies in North America. Energy companies account for approximately 19.7% of the index, second only to the highly weighted financial industry. The year hasn't been kind to energy companies with the TSX Energy Index down approximately 12% — one of the biggest market laggards. In contrast, the price of oil is flat year to date (YTD), barely eking out a 1% gain. So, why the disconnect?

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There are two major issues facing Canadian oil and gas companies. For starters, there is a significant pipeline export glut, and Canada is producing more oil than the pipelines can handle. Secondly, politics at the federal and provincial level has stymied new investment progress. There are significant disagreements between provinces, and the federal government's green mandate is at odds with the need for more energy infrastructure to support oil and gas production. As a result, international companies have been exiting the sector at a record pace, and new investments are hard to come by.

The good news for investors is that these uncertainties have led to great investment opportunities. The market oversupply is slowly dissipating, and there is recent news that Russia and the Saudis are on the verge of a landmark deal to curb oil production for the next 20 years. If a deal is achieved, it could not only mean further price stabilization, but could be a catalyst to propel the commodity higher. Likewise, energy prices tend to move in lock-step with inflation. Therefore, it stands to reason that as interest rates rise, so too will the price of oil. In combination with the balancing of supply and demand, look to these two stalwarts for their attractive risk/reward profile.

Attractive risk/reward profile

Enbridge Inc. (TSX:ENB)(NYSE:ENB) is Canada's largest energy company by market capitalization. After a tough year in which the market punished its stock, the company is executing its deleveraging strategy in the wake of its Spectra Energy acquisition. The company is trading at a respectable price-to-book (P/B) ratio of 1.32 and forward price-to-earnings (P/E) of 15.5. Despite its high payout ratio, the dividend is safe, and it expects to grow dividends by 10% through 2020.

Next on the list is **Suncor Energy Inc.** (TSX:SU)(NYSE:SU), Canada's largest integrated oil and gas company. The company is considered best of breed in the sector, and as such it typically trades at a premium to its peers. Despite this, the company's 9% slide YTD has made for an attractive entry point. Suncor posted blowout earnings in the fourth quarter, hiking its dividend 12.5%, while achieving record quarterly cash flows of $3 billion. Suncor is one of the most well-managed oil and gas companies in North America.

Canadian energy companies have struggled, and although they may not have bottomed, the current risk/reward profile is too great to ignore. It's only a matter of time before Canada solves its oil glut, and the divide in politics will eventually subside. There are a number of undervalued energy companies on the TSX but investors looking for less uncertainty are best to stick with the best management teams.

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