What's Next for TSX Energy Stocks as Bears Dominate?

Description

While it seemed like the beginning of a multi-year bull run for TSX energy stocks, they have lost their sheen of late — much earlier than expected. Since June, they have lost 25% on average, notably underperforming broad market indices. So, what's next for oil and gas names? Is it really a start to a long-term downtrend?

Declining crude oil prices amid rising recession fears remain a critical risk for the sector. Market participants fear that a severe recession might dent the global energy demand, ultimately pulling the prices down. In that case, oil and gas producers would see a reversal of the earnings growth and stock prices. However, it is still a remote scenario.

Supply constraints to dominate global energy markets

Even in the case of a recession, energy demand will still be higher than supply. According to the International Energy Agency's Oil Market Report of July 2022, global crude oil demand will average 101.3 million barrels per day (mb/d) this year relative to the supply of 100 mb/d.

Interestingly, the global supply is not increasing at the same pace as the demand. For example, OPEC+ (Organization of Petroleum Exporting Countries, including Russia) agreed to increase production by only 100,000 barrels per day in September, which is much lower than expected. Moreover, for the last several months, many OPEC member countries are not producing enough to fulfill their set quota, aggravating the supply issues.

European countries and the U.S. have put economic sanctions on the world's second-biggest oil producer, Russia, after its war with Ukraine, again, negatively affecting the energy supply.

The demand scenario looks all the more promising. China, the second-largest oil consumer globally, will likely see higher oil demand once the COVID-related restrictions wane. In addition, the U.S. will likely look to replenish its strategic petroleum reserves, probably in the second half of 2022, whichcould drive the demand. So, in a nutshell, the demand-supply imbalance will most likely remain skewedand could continue to support higher prices.

Strengthening balance sheets

Since the pandemic, strong capital discipline has been the highlight for almost all oil and gas players. They have not allocated a much higher capex for production growth, despite the strong price environment. Instead, they deployed the incremental cash flows to repay debt and for shareholder dividends.

For example, **Canadian Natural Resources**, the country's biggest energy company by market cap, saw its net debt drop to $13.6 billion as of June 30, 2022. This was a massive deleveraging from $22.6 billion at the end of 2020. Declining debt balance lowers the interest outgo, improving profitability.

Even though oil has fallen from its May 2022 levels, it is still trading much higher than last year. So, TSX energy producers will likely continue to see deleveraging and strong free cash flow growth for the next few quarters.

Dividend hikes and attractive valuation

Apart from the superior financial growth, Canadian energy companies have issued generous dividends recently. **Tourmaline Oil**, Canada's biggest natural gas producer, has issued special dividends thrice this year, thanks to its robust cash pile. So, in the last 12 months, it has paid a total dividend of $6.28 per share, implying an appealing yield of 9%.

In addition, TSX energy stocks are trading 10-12 times earnings and look attractively valued. They are trading 2.5 times their enterprise value to cash flow. Their strong earnings growth prospects, improving balance sheets, and dividend-growth potential rather call for a premium valuation.

So, although oil prices have brought down TSX energy names of late, there is good ground that calls for a trend reversal. Undervalued stocks, strong total-return potential, and a healthy macro environment could create substantial shareholder value.

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