Why Canadian Oil and Gas Stocks Offer Striking Growth From Here

Description

After rallying for several months and creating immense value for shareholders, Canadian oil and gas stocks have taken a hiatus in the last few months. However, they still offer handsome growth prospects for long-term investors. Considering their earnings expansion, improving balance sheets, and energy market fundamentals that point to higher oil prices, they offer sizeable shareholder value.

Earnings growth and deleveraging

Energy companies saw their earnings and free cash flows multiply this year, as oil prices breached the US$130-a-barrel level in the second quarter (Q2) of 2022. This recovery was remarkable given the massive earnings drop producers saw in 2020 when oil prices tumbled below US$20 a barrel amid the pandemic.

What's notable about the post-pandemic earnings surge is the capital discipline. Instead of allocating incremental capital to production growth, oil and gas producers earmarked funds for debt repayments and shareholder returns.

While Canadian energy companies, on average, had a net debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio beyond three before the pandemic, it has now fallen close to 0.7. This suggests a substantial balance sheet improvement and improved profitability for the future amid lower interest expenses.

For example, **Cenovus Energy** (TSX:CVE)(NYSE:CVE), the third-biggest energy company on the TSX, reported free cash flows of $2.8 billion in the first half of 2022. In the same period last year, it posted free cash flows of $516 million. Thanks to such a steep growth, Cenovus managed to pay down the debt much faster.

Its net debt fell from $16.5 billion in Q1 2021 to $10.4 billion in Q2 2022. It also tripled its annual shareholder dividends to $0.42 per share, implying a yield of 1.7%. CVE stock has returned 70% so far in 2022, while TSX energy stocks, on average, have returned 62%.

Geopolitical tensions suggest higher oil and gas prices

Aggressive deleveraging and focusing on shareholder returns have been the theme across Canadian energy companies. So, energy has become one of the most adored areas in the broader markets.

And, importantly, the trend could continue, as the global energy market fundamentals indicate much higher oil prices. That's because the Russia-Ukraine war and ensuing sanctions are expected to create long-lasting supply woes.

The demand will move rather higher considering re-openings in China and re-filling of the U.S. reserves. All top bodies, like the Organization of the Petroleum Exporting Countries, International Energy Agency, and Energy Information Administration, see higher demand for crude oil next year. So, the near-term demand-supply imbalance indicates energy commodity prices will likely move higher.

This again means strong financial growth for upstream oil companies and higher shareholder returns.

TSX energy stocks: Valuation

Although energy companies are expected to grow faster, TSX energy stocks are trading at appealing valuations. On average, they are trading at an enterprise value to cash flow ratio of 2.8, which is much lower than their historical averages.

Vermilion Energy (TSX:VET)(NYSE:VET) stock, one of the top-gainer TSX stocks, has returned 215% since last year. It is trading at an enterprise value-to-cash flow ratio of 2.6 and still looks attractively valued. It will likely keep rewarding shareholders given its undervalued stock, significant exposure to Europe, and earnings-growth potential.

Many TSX energy stocks will likely change course soon and head towards their previous highs. So, the recent correction could be a valuable opportunity for those who missed the bus last time.

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