What Share Buybacks Mean for Energy Investors in 2023 and 1 TSX Stock That Could Outperform

Description

As crude oil prices breached $130 levels last year, oil and gas production companies saw record free cash flow growth. However, companies still have one main priority for the windfall cash flow – shareholder returns. Energy companies are deploying billions for dividends and share buybacks in 2023, which will likely drive shareholder value.

How does that place energy stocks this year, especially when oil prices have retreated and the economy seems ready for a downturn?

TSX energy stocks and share buybacks

Canada's four largest energy producers by market cap – **Canadian Natural Resources** (TSX:CNQ), **Suncor Energy** (TSX:SU), **Cenovus Energy** (TSX:CVE), and **Imperial Oil** (TSX:IMO) – spent a whopping $17.5 billion collectively on share buybacks in the last 12 months. According to recent management commentaries, they will continue buying back their shares this year as well.

Energy companies are in no hurry to deploy additional capital to increase production. Even when they are sitting on record financial growth and oil prices are at reasonable levels, North American oil production is expected to grow 4% year over year in 2023. Shareholder return is the only place to go for incremental capital, as global energy markets remain tight on the supply side.

Why is a share buyback a preferred route of management?

Even if shareholders prefer returns in the form of dividends, share repurchases offer more flexibility to management. When companies buy back their own shares, it indicates that the shares are undervalued and helps boost share prices in the short term.

Moreover, as the number of total outstanding shares falls on buybacks, per-share earnings ultimately increase. Plus, even if management keeps the total dividend amount the same, each shareholder receives a higher absolute amount of dividend. Also, share repurchases grant more voting power to management.

TSX energy stocks have come down 20% in the last few months as oil and gas prices notably corrected. This might be the time when companies ramp up their buyback activity, ultimately protecting stocks from substantial drawdowns.

South of the border, peers and energy giants **ExxonMobil** and **Chevron Corporation** have recently announced a share buyback program of almost US$125 billion.

Deleveraging

For the last few quarters, energy companies focused on debt repayments as a primary use of their incremental free cash flow. Upstream energy companies have historically had concerning leverage levels. However, they are some of the well-capitalized companies.

To be precise, the TSX energy index had an average net debt-to-EBITDA ratio of close to 3x pre-pandemic, which has now fallen below 0.5x. Net debt to EBITDA (Earnings before interest, tax, depreciation, and amortization) is an important metric to measure a company's leverage. It indicates how many years a company would take to repay debt.

While declining debt makes the balance sheet stronger, lower debt servicing costs also improve the company's profitability.

Notably, Canadian companies saw substantial improvement in their balance sheets with aggressive deleveraging last year. Now that much of the debt target is already achieved, companies will see a higher allocation of free cash flows to share repurchases. Many Canadian energy companies intend to allocate 75% of their free cash flows to shareholder returns in 2023.

With significant buyback activity, visible dividend growth, and sound capitalization, energy stocks look well-placed to outperform in 2023 as well.

#1 TSX energy stock

Canada's largest Canadian Natural Resources is one of the top picks in the sector. CNQ stock returned $10.1 billion via shareholder dividends and buybacks in the last 12 months. Notably, it started 2023 with a bang and repurchased more than three million shares in January 2023. Driven by its free cash flow visibility, CNQ will likely keep pleasing shareholders with higher dividends, too. Management intends to pay a dividend of $3.40 per share, implying a juicy 4.3% yield.

CNQ's debt has come down from $23 billion in 2020 to $14.5 billion at the end of Q3 2022. The company will release its Q4 2022 earnings early next month. How its financial growth and balance sheet take shape will be interesting to see. Canadian National Resources is well placed to outperform its peers based on its scale, relatively lower leverage, and valuation in the strong price environment.

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2. Investing

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1. TSX:CNQ (Canadian Natural Resources Limited)
2. TSX:CVE (Cenovus Energy Inc.)
3. TSX:IMO (Imperial Oil Limited)
4. TSX:SU (Suncor Energy Inc.)

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