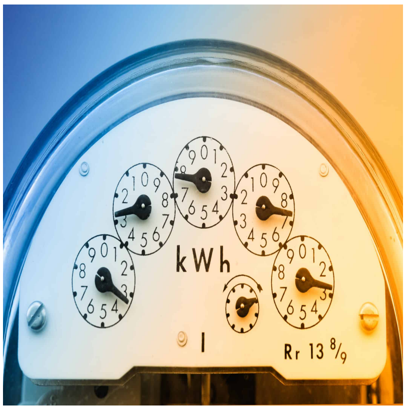

Energy Investing: What Every Canadian Needs to Know

Description

Investors' appetite for energy stocks is cyclical – and energy is facing relentless demand these days now that supply is less certain. Should you get in on what we think could be a multiyear energy boom?

Here's what savvy Canadian investors need to know about energy investing today, straight from *Motley Fool Hidden Gems* advisor Jim Gillies.

Why is there an energy supply crunch in the market today?

Well, it's people! The global population continues to grow, and energy needs are struggling to keep up with demand. And the world needs a lot of energy … as we come out of the pandemic, as we keep adding people to our global population, as we keep having people wanting lifestyles more like what we enjoy in the West, which are inherently higher energy-consumptive. We have found ourselves with record worldwide demand.

To put that into numbers, global demand is about 175,000 terawatt hours per year. What this means is worldwide energy demand would be like powering 16.5 billion average North American sized homes.

Not only are we seeing record demand, but global energy use is continually growing. Demand has been growing at just under a 2 percent annual rate for the past three decades. So the question becomes, where do we get it? How do we fill that bucket? We don't care how we fill it. But we know we need to fill it.

The big three fossil fuels account for almost 80 percent of the share. Oil, gas, and coal are the big three. It was about 79 percent in 2019. The problem is, it was about that same percentage 10 years ago, 20 years ago, 30 years ago as well. Now there has been a shift more from coal to gas within that fossil fuel share, but the overall share of fossil fuels has remained the same.

What this suggests is that, for all of the talk of the move to renewables – to the expansion of wind and solar and geothermal – they've not yet made a dent in filling that bucket. So now we have a very interesting problem to solve.

What does the energy shortage actually mean in the real world?

Energy is THE prime commodity – it's the thing that underlies all other products. It takes energy to produce products, it takes energy to bring products to market. Consumers' ability to afford energy affects their ability to demand goods in the market. Diesel prices at record highs certainly impact company margins. As gasoline prices get higher, people are less likely to go drive around and take vacations.

The U.S. restaurant chain **Cracker Barrel** (Nasdaq:CBRL) recently cited a slowdown from their over-65 customers. If you think about the people who are going to be first hit by these increases in energy prices, it's the marginal consumer. In a place like North America, that would be folks on fixed income.

On a global basis, it would be that developing countries bidding for supplies are up against countries in Europe and North America.

Then even outside of these core commodities, there are others affected. You look at plastics and building materials, certainly an impact there. The big impact that I don't think a lot of people realise is in food production. One of the key inputs to global food production is natural gas, which is used to make ammonia, which is used to make nitrogen fertilisers. I saw some research that without the nitrogen-based fertilisers produced largely from natural gas. it would be impossible to feed, at current levels, nearly half of the world's 8 billion people.

When you look at shortages in things like oil and gas, it's not just okay. You can't drive, it can impact food demand. As the prime commodity, energy touches all parts of the economy.

What does the energy shortage mean for investors?

Just to go back a little bit, I used to be a real negative on the oil and gas space through much of the 2010s. My logic was simply this: Most of these companies were spending about $20 for every $1 they pulled out of the ground. But when times were good, because you had a $100-plus barrel oil, it looked like the companies were doing well. They also paid a dividend, but of course many of these businesses were cash flow negative. They would make it up through continuous equity and debt issues.

There was this mentality that high commodity prices would be here forever. But you can't control that as an E&P – an exploration and production – company. So when we did start to get a slowdown, a bunch of these players went down 70% to 80% percent. Dividends were slashed if not eliminated, and financing dried up.

The estimates from the U.S. shale boom, from the early middle part of last decade, are that between $700 billion to $1 trillion in capital raised for the industry didn't earn close to its cost of capital. That has made the industry as a whole and the financing side of things somewhat reticent to dig in now – precisely the time when we arguably need more energy.

The financiers have said, hey, the last time we raised money for you, we lost our shirts. Investors lost their shirts. Everyone wants to see free cash flow generation, see the companies generating money. So we've got ourselves a little bit of a pickle.

I will argue this is probably the most important industry. Everything else stops without it. We have an energy industry that is coming out of the pandemic and has unrelenting demand. And it has historically under-invested in itself since 2014, 2015. Now we've got oil prices running. Throughout all of this, as some of these energy commodity companies are now being beaten up for having record profits because their investors are demanding real returns. And so any money they pay out in dividends is money they're not reinvesting into the business to make more energy. It's a prime setup for a multiyear energy boom.

What's a good energy stock to buy today?

My favourite E&P company that we've recommended in *Motley Fool Hidden Gems* is **International Petroleum** (TSX:IPCO). Mind you, it's a small energy stock because *Hidden Gems* is a small-cap investing service.

It has decades of experience in oil and gas and mining, and they figured things out faster than some of their compatriots so they're very free cash flow focused. The company has very low leverage, and at present oil prices, the operating leverage of the company is stunning. So they are in the midst right now of buying back about 9 percent of the stock. I suspect they'll pay for that with all the cash they'll generate in the quarter.

- Related: Top Canadian Oil Stocks

The Foolish bottom line

Energy is an interesting place to invest today – even though it wasn't a few years ago – because the companies are finally producing meaningful cash. As long as the demand cycle continues in an upward trajectory, energy investors should be rewarded.

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