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Sensible Purchases in Canadian Energy

Berkshire Hathaway, a holding in the QV Global Equity Strategy, released its 2017 Annual Report to Shareholders last weekend. Reading the Chairman's Letter is always enlightening with its wisdom on subjects like the dangers of investing with borrowed funds, how stocks "surge and swoon" around underlying value in the short term, and how buying equities at sensible multiples will reduce risk over longer time horizons.

QV's investment criteria are similar to the qualities that Warren Buffett describes in searching for new business acquisitions: "[T]he key qualities we seek are durable competitive strengths; able and high-grade management; good returns on the net tangible assets required to operate the business; opportunities for internal growth at attractive returns; and, finally, a sensible purchase price." Mr. Buffett goes on to describe the environment for new business acquisitions as follows: "That last requirement proved a barrier to virtually all deals we reviewed in 2017, as prices for decent, but far from spectacular, businesses hit an all-time high."

We believe finding equity investments at prices that offer attractive reward versus risk generally remains a challenge today. Even in Canada, where the market continues to lag the S&P 500 and MSCI World indices on a year-to-date basis, valuations are elevated. We are careful, though, not to paint all Canadian sectors with the same brush. Canada's energy sector, in particular, has been weak through 2017 and thus far in 2018, returning -20% against an 18% recovery in benchmark crude prices over the same period. Valuation multiples for this group appear to be at or near historic lows in absolute and relative terms.

Few of the 50 companies within the S&P/TSX Composite's energy sector would pass QV's criteria for investment, outside of valuation. But even those that do are being overlooked by investors due to what we believe are temporary issues weighing on Canadian energy prices, namely market access.

The price difference between heavy and light crude grades, often referred to as the WCS-WTI spread, has grown unusually wide in 2018. This is mainly the result of transportation constraints, such as pipeline capacity and rail commitments, out of Canada's oil producing regions. Most of Alberta's oil producers are to some degree exposed to the price of Western Canadian Select (WCS), which puts revenues at risk. We don't know when this issue will be resolved, but research suggests adequate takeaway capacity independent of political matters should come within the next three years.

Meanwhile, opportunities have surfaced to pay sensible prices for good energy businesses. One recent example in the QV Canadian Equity Strategy is the initiation of Cenovus Energy Inc. in late January. Cenovus is an integrated energy producer focused on developing its low-cost Canadian oil sands assets. It also owns a large land base of gas reserves, 50% ownership in two US refineries and a crude-by-rail facility in Edmonton. These assets combined are capable of generating free cash at much lower energy prices. Cenovus trades at a 40% discount to its book value and at an attractive price-to-cash flow multiple of 4.5x compared to integrated peers at 7.0x. However, prior management actions have left blemishes on the company. It made headlines in March 2017 by paying nearly $18 billion in a largely debt funded deal to acquire Canadian oil and gas assets from ConocoPhillips. This move left the company with little financial flexibility or room for execution error. The market responded by reducing the value of Cenovus' shares by 48% in the ensuing months.

We see potential in Cenovus today, after it reduced its debt by 30% through non-core asset sales and found a new leader committed to further deleveraging. Oil differentials are likely to keep Cenovus' shares from outperforming in the near term, but over time when the industry dust settles, there is tremendous value to be realized in this business.

Mr. Buffett and his team of investment managers have shown interest in Alberta's oil sands producers in the past. Maybe it's time to have another look?