PALISADE CAPITAL

# Oil and Gas Markets Are Changing

February 2024

In our previous month's client conference call, we discussed the dynamics of the energy market, particularly focusing on natural gas and crude oil prices. The central theme revolved around the adage "the cure for low prices is low prices," underscoring recent developments in natural gas production and its economic implications. Since that call we've observed significant production curtailments by gas producers like Chesapeake Energy, aimed at counteracting uneconomically low natural gas prices. This strategic move has sparked a notable shift in the market, positively influencing both natural gas prices and stock valuations.

## North American Energy Markets:

- Chesapeake Energy announced curtailed production due to uneconomic pricing, reducing their 2024 production guidance by approximately 20% from Q4 2023. Other companies have recently followed Chesapeake's lead.
- U.S. natural gas prices rallied over 25%, from around $1.50/MMBtu to $1.95/MMBtu, following these various curtailment announcements.
- U.S. natural gas production has dropped from 105 Bcf/d to 101 Bcf/d, signaling a serious attempt at supply limitation.
- Meanwhile, stock prices of gas producers rose, with Chesapeake up 7%, Peyto up 10%, and Advantage reaching a new 52-week high.
- Key factors for a sustainable rally in oil and gas stocks include a warm summer, stability in pipeline operations, increased refinery runs, and the prospects for a change in the Canadian federal government.
- Canadian Natural Resources, a leading operator, has seen its stock reach an all-time high, with a Debt-Adjusted Cash Flow Multiple of 7.7x, outperforming other producers. This may be a harbinger of things to come for smaller operators having some success at maximizing returns to shareholders.

## Near-Term Outlook:

- We believe that Canadian stock markets should continue to perform well through the balance of 2024, as the positive trends that started in November 2023 are still in place.
- In February, economically sensitive sectors like oil and gas caught up to some of the more interest-sensitive sectors that had rallied strongly in November and December. We would expect that back-and-forth to continue between growth and value sectors outperforming at different periods in 2024.

The oil and gas sector has rallied for one month, so it's important to not read too much into the move. However, we think the sector will benefit from the favorable tailwinds that we see for Canadian stocks in 2024 (lower interest rates, attractive valuations, and economically sensitive sectors) and may even have the potential for a little valuation improvement if the recent trading action in Canadian Natural Resources is indicative of what investors are willing to pay for a well-run oil and gas company. Ideally, we see oil and gas working as part of an overall positive outlook for Canadian equities in 2024.


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**February 2024**

Fellow Palisade Investor,

Please find attached our February 2024 Monthly Update, as well as the Fund Fact Sheets for the Palisade Funds. **This month's client conference call is scheduled for Thursday, March 14th at 11am MT.** We will use a different service for our conference call this month as we switch over to Microsoft Teams from Zoom, but the process will be the same if you wish to join the call. You can connect either through your computer or by calling a phone number. The Teams meeting details will be provided the morning of the call. In conjunction with this call, we will be emailing out a presentation that contains data and charts to further detail our thought process and outlook. We look forward to speaking with you then and answering any questions you may have.

All Fund performance figures are shown net of fees and expenses and include changes in security values and distributions paid. They do not assume the reinvestment of distributions. The Palisade Vantage Fund currently pays a regular quarterly distribution of $0.11 per unit, or $0.44 per unit per year. The Palisade Select Fund and Palisade Absolute Fund pay irregular annual distributions for years in which taxable net income is positive.

## MARKET COMMENTARY

In our client conference call last month, we spent some time talking about "the cure for low prices is low prices" as it related to natural gas, and to a lesser extent to oil prices. In the three weeks since that call, we have seen gas producers announce production curtailments to avoid producing natural gas at a price that is uneconomic. The most notable of these was from US producer Chesapeake Energy, which announced cuts to capital spending and forecasted production for 2024 to be down approximately 20% from the fourth quarter of 2023. There have been other companies announcing production cuts, but the Chesapeake news seems to have been the specific catalyst to create a low in natural gas prices. Just prior to the Chesapeake announcement, the price for natural gas in the US was close to US$1.50/MMBtu. Natural gas rallied over 10% on the day of the news and has continued to trade higher in the interim, now trading at US$1.95/MMBtu and up over 25% in a little over two weeks. In the last month, natural gas production in the US has gone down from 105 Bcf/d to 101 Bcf/d, indicating that producers are serious about limiting supply and attempting to improve prices.

Stock prices have also reacted positively to the news, despite continued short term concerns around natural gas inventories being well above the five-year average and winter weather seemingly going out like a lamb. Chesapeake has rallied 7% since the announced production curtailments, while Canadian natural gas producers like Peyto and Advantage have rallied 10% and 14%, respectively. In the case of Advantage, the stock recently traded at a new 52-week high, which seems a little hard to believe given the weakness in natural gas prices. The stock market adage of a "wall of worry" being needed to incent stocks to rally has certainly been accurate in the case of Advantage and many other Canadian natural gas producers.

So, if the supply/demand picture looks a little weak for at least the next six to nine months, what is needed to see a sustained continuation of the rally that we've experienced in oil and gas stocks over the last month?

1) A warm summer would be helpful to get natural gas inventories into a more balanced state;
2) Line fill and operational stability for the TransMountain pipeline expansion;
3) Improved refinery runs in the US, increasing the demand for oil;
4) Operational updates for LNG Canada showing continued expectations towards start-up in 2024 with full operating capability in 2025. Signs of approval of the phase 2 expansion would also be welcomed;

5) Indications that a Federal election in 2025 (or hopefully earlier) point to a change in government, which would bring with it a change in policies that would be more beneficial to the oil and gas industry; and
6) Ongoing economic growth and stability in North America to provide a backstop of firm demand for both oil and natural gas.

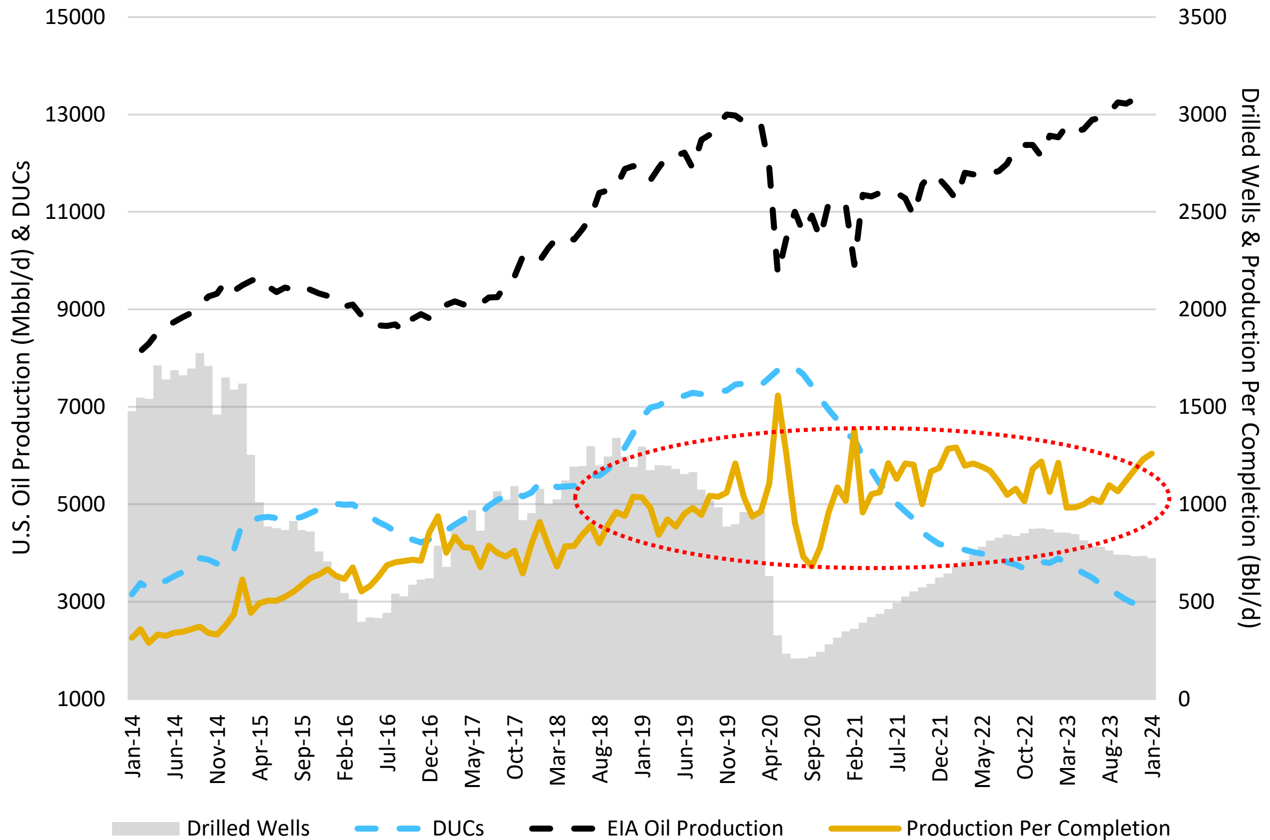
These are all events that could have a decent likelihood of occurring and after a long wait these are all catalysts that will play out over the next nine months (in the case of TransMountain, LNG Canada and a change in the Federal government, it feels like decades, not years in the making). So, what happens if these all go off without a hitch? After all, for most oil and gas stocks the rally has only been happening for the last month. What will allow the stocks to extend that rally for six months or more? Is there a scenario in which stocks can "re-rate" and maintain a slightly higher valuation through a cycle than they have in the last few years? Even as that sentence was typed it feels like it might be a little early to be thinking about putting the cart before the horse, let alone actually doing it, but from an investment perspective it warrants consideration.

The reason to mention the idea now is because that's what appears to be happening with the stock of Canadian Natural Resources Limited ("CNRL"). The company is acknowledged as the best operator in Canada, and potentially North America. They have high quality and sustainable assets, they have made opportunistic acquisitions at favorable prices, they continue to increase the dividend and they maximize free cash flow and use proceeds to buy back shares. In short, they are doing exactly what investors have been demanding of the entire industry for the last five years. As a result, the stock is now trading at an all-time high and at a cash flow multiple that most analysts didn't think was possible in the new "low growth, maximize cash flow" regime.

CNRL stock trades at a Debt-Adjusted Cash Flow Multiple (DACF) of 7.7x using current strip pricing. For frame of reference, the trailing 12-month DACF has been between 3.5x and 8x in a normalized commodity price environment since the oil price crash of 2014. Large cap US producers PXD and FANG now trade at 7.0x and 6.1x, respectively. Canadian mid-cap producers currently trade between 3.5x and 6x. CNRL will always trade at a premium due to its size, liquidity, scale and "anointed" status, but what should the smaller producers trade at if they can replicate even a modest measure of the operational success of CNRL? Again, they won't trade at the same multiple as CNRL, but if a quality company (assets and management) can consistently buy back shares, pay some sort of dividend and generate a reasonable free cash flow yield, could their stock trade at a 5x DACF multiple instead of 3.5x DACF? We think that's absolutely possible. The longer CNRL can maintain its premium multiple, the more likely it becomes that the cheaper stocks in the Canadian oil and gas universe can pick up a multiple point or two if warranted by their operating history.

The last point to highlight is expressed in the chart below. Increasing oil supply has been a constant source of frustration for crude oil bulls as technological advancements have improved well productivity, and easy production additions from previously drilled but uncompleted oil wells ("DUCs") have driven up US oil production to new record highs despite lower rig counts and constrained capital spending budgets focused on generating free cash flow rather than exploration. The blue dotted line in this chart is the number of DUCs, which has been declining since COVID, and is now at the same level as it was a decade ago. The yellow line is the production per well completion, which is up substantially over the last ten years, but has been more rangebound in the last five years.

If we can enter an investment environment where investors recognize that easy production additions from the DUC inventory and ongoing improvement in well completion technologies might be a little harder to come by, that could also drive up the valuation multiples of oil and gas stocks because the risk of a significant decline in oil prices would be much lower, and thus the stability of producer cash flows would be higher, enabling companies to provide an attractive total return that would include dividends, share buybacks, debt repayment and some cash flow growth.




We acknowledge that we're presenting a "Goldilocks scenario" for the oil and gas sector over the next few years with the above commentary, but it is possible, and we wouldn't even consider it if it wasn't for the way that CNRL stock is trading and the valuation multiple that investors are now applying to the stock due to the fact that they are executing well and providing a robust combination of shareholder-friendly policies on a consistent basis.

## PALISADE FUND COMMENTARY

The **Palisade Select Fund** ("PSF") was up 5.7% in February. The S&P/TSX Capped Energy Index ("Energy Index") was up 7.9% in a rally that actually started while gas prices were continuing to move lower in the early part of the month. The WilderHill Clean Energy Index "(ECO") was essentially flat for the month.

As mentioned above, we saw oil and gas stocks outperform weakness in natural gas pricing and benefit from rotation from leading sectors into the space. In some cases, we're seeing new 52-week highs in leading names across various subsectors. In oil-weighted names, there are new highs in CNRL and Athabasca. In gas-oriented stocks, there are new highs in Advantage Energy and ARC Resources. Even in the oil services subsector there are new highs in Secure Energy Services and (almost) in PHX Energy Services. The reason to mention this is to highlight that there are still many stocks that are well below recent highs with room to move higher. Hopefully, the names above will ultimately be seen as leaders that are proactively moving higher in advance of a wider rally in other names like Cenovus, Crescent Point, Kelt and NuVista.

It's also worth highlighting that one of our core holdings, Enerplus, received a takeover offer this month from Chord Energy that saw the Enerplus share price trade up by 10% on the day of the announcement, which turned into a 23% gain for the month. This is the most recent in an ongoing

trend of mergers in the oil and gas sector. We expect further merger announcements, which would hopefully serve as a catalyst to bring more generalist investor money into the sector.

The **Palisade Absolute Fund** ("PAF") was up 0.9% in February. Our slightly defensive posture from early in February was reversed quickly as markets shrugged off the risk of interest rate cuts likely not occurring as soon as previously expected. Net exposure in PAF was around 20% early in the month but was increased to 40% and currently sits at 44% net long. Thematically, there are not many changes to report. Our core Canadian growth stocks are supplemented by mid-capitalization companies that are executing well. We have core holdings in companies like Dollarama and Constellation Software, and those are supplemented by positions such as Element Fleet Management, Equitable Bank and Coveo Solutions.

On the short side of the ledger, it's been harder to find contributing shorts in the current market, but we maintain shorts in MTY Food Group, Maple Leaf Foods and Canadian Tire. In some instances, flat performance from the shorts is an acceptable outcome while the broader market is bullish. This month we also converted a short position in Nutrien to a long position as all the bad news seems to be priced into the stock and the company has set achievable guidance for the balance of the year. It's pretty rare that we switch a position from short to immediately long, but we think that Nutrien will benefit from the positive backdrop we see for Canadian markets in the balance of 2024 and it has the potential to outperform conservative guidance that it recently provided to investors.

The **Palisade Vantage Fund** ("PVF") was up 0.7% in February after taking a breather in January following some significant gains to end 2023. The S&P/TSX Composite Total Return Index was up 1.8% in February. The S&P/TSX Canadian Dividend Aristocrats Index was up 0.5% for the month.

The pause that PVF took in January (essentially flat for the month) after two strong months proved to be just a breather as the interest-sensitive stocks in the fund returned to strong performance in February. We continue to believe that a backdrop of economic stability and lower interest rates will provide a tailwind for Canadian stocks, which should manifest in broad upward participation across various sectors. This trend started in November 2023, and we think it can continue through the balance of 2024.

We added to our real estate investment trust ("REIT") holdings this month by initiating a position in Sienna Senior Living. The stock showed up in our growth screen and nicely supplements our long-term holding in Chartwell Retirement Residences and our broader multi-family real estate holdings in Boardwalk REIT.

As outlined above, we believe that Canadian equities will continue to perform well and in a reasonably stable manner through 2024. If you have any questions, please feel free to reach out at any time.

All the best,

**THE PALISADE CAPITAL MANAGEMENT TEAM**

Please note that it is the responsibility of each investor to inform Palisade Capital of any changes to the information provided to us on the most recently completed Know Your Client ("KYC") information form or subscription agreement. Please contact Marni Friesen at (403) 531-2673 or marni@palisade.ca to provide any such updates. If you no longer wish to receive the Monthly Update, please send an email to info@palisade.ca.

*All Palisade Fund performance figures are shown net of fees and expenses and include changes in security values and distributions paid. They do not assume the reinvestment of distributions. Income taxes would have reduced returns. The Funds are not guaranteed. Performance of the Funds will fluctuate and past performance may not be repeated. To establish relative performance yardsticks for the Palisade Funds, we provide comparative references to the S&P/TSX Composite Total Return Index ("TSXTR"), the S&P/TSX Capped Energy Index ("Energy Index") and the WilderHill Clean Energy Index ("ECO Index"). Those indices are relevant to our portfolio content however the TSXTR, Energy Index and ECO Index data is provided for general reference purposes and their content should not be construed as directly comparable to the content of the Palisade Funds.*