Laurus
MONTHLY UPDATE
11
2014

"Successful investing is anticipating the anticipations of others…"

-- John Maynard Keynes

Unless you've spent the last number of weeks cocooned in some far away locale without access to media (for which I would offer my congratulations), the ongoing saga of OPEC oil production and its resulting impact to oil prices has, no doubt, reached your ears.

Oil prices have fallen dramatically. West Texas Intermediate Crude ("WTIC") is currently trading around $66 as this note is being written, down from slightly above $106 in June. There are certainly plenty of opinions on what caused this price rout, but we thought it might be worth looking at whether investment opportunities can be found as a result.

To be sure, a decline in production will result. The vast majority of producers require oil prices to exceed $75 to balance their budgets, with many more requiring much higher prices as Chart #1 (see page 2) on OPEC production illustrates. That said, OPEC production has remained steady while the US, on the back of new drilling technologies in their shale fields, has seen a dramatic rise in production as shown in Chart#2 (see page 2).

Yet it is not production that is creating the problem – it is the demand side of the equation. While supply has grown steadily with the increase in more "expensive" light oil out of the US, demand has fallen as a result of economic weakness in both China and Europe.

There is one ray of hope however – the falling Canadian dollar. With WTIC measured in US dollars, the Canadian dollar decline has made up for a great deal of the downward price spiral of oil. For example, at the beginning of 2014, the WTIC price of $94 was roughly the same in Canadian and US dollars as the loonie was at par with the greenback. However, with the Canadian dollar now at 88¢ US, the current WTIC price in Canadian dollars would be almost $78, or a fall of 17% - not 28% as indicated by the WTIC price.

In environments like this, valuation gets chopped and opportunities arise.

Canadian Energy Services & Technology Corp. (CEU-T), held in the Laurus Enterprise Fund, offers a sophisticated set of proprietary, technically-advanced chemical products and services for the entire life cycle of oil and gas fields. CES's ample free cash flow has allowed them to acquire complimentary businesses, and in March 2013 CES acquired JACAM, a manufacturer and distributor of oilfield related specialty chemicals.

On October 22nd, 2014, we got an in-depth look at the business by participating in a tour of JACAM's manufacturing facility in Sterling, Kansas. JACAM's products include lab-developed, patent protected proprietary additives for managing corrosion and lubrication in oil and gas production. CES plans to cross-sell these products to their existing customer base in drilling fluids, where they enjoy market share of 30% in Canada and 6% in the US. What differentiates JACAM from peers is the ability to manufacture the basic chemical components, allowing the company to control the value chain and capture more margin. Even in a tough oil & gas capex environment, we expect CES's industry-outpacing revenue growth rate and recycling of cash into accretive acquisitions to continue, thanks to management's proven ability to apply innovative chemistry to solving problems for oilfield operators, and US market share expansion potential.

Another company in the Enterprise Fund with above-average future prospects is **Computer Modelling Group (CMG-T)**, especially if prices remain low. Their proprietary reservoir modelling software allows oil producers to develop reservoir simulations to enhance oil recovery for unconventional resource plays. Over the past fifteen years, CMG has developed over 550 clients worldwide, including all of the top multinational and national oil and gas companies.

In a meeting with the company in Calgary a week ago, we discussed the impact of vastly lower oil prices to the CMG business. Surprisingly, management met lower prices with enthusiasm. Apparently, when prices are high, producers worry less about efficient production and more about how fast they can produce. When prices fall, "efficiency in engineering" becomes paramount and usage of the CMG modelling techniques becomes essential as a tool to evaluate and determine the optimal method for recovering resources on a specific project.

We have had experience with both Canadian Energy Services and Computer Modelling management groups for over five years. Their considerable cash flow growth, strong management experience, and dominant market positions will keep them market leaders for the foreseeable future.

Like most things in life, the ongoing price of oil will be subject to the balance between supply and demand. Lower oil prices will result in project delays and production cuts. Eventually, these cuts will result in supply dwindling below demand. When that occurs, prices will begin to rise once again.

Performance

Obviously, the biggest news of the month was the downturn in energy stocks. The producer sub-index fell 13% while drillers pulled back almost 19% and none of the other sub-indices faring much better. The fallout impacted related industries as well – the chemicals group, largely supporting oil and gas drilling, fell 11%, while construction and engineering companies combined declined over -7%. Opportunities are becoming apparent in the energy sector as valuations become depressed in the cycle.

The 0.2% increase in the Enterprise Fund in November looks quite strong relative to our peer group and better than the S&P/TSX Small Cap Index performance of -0.1%. Large cap stocks significantly outperformed the small cap index, as evidenced by the S&P/TSX60 Index (largest 60 stocks in the Canadian index) return of 1.7%.

Chart 1 Source: Reuters

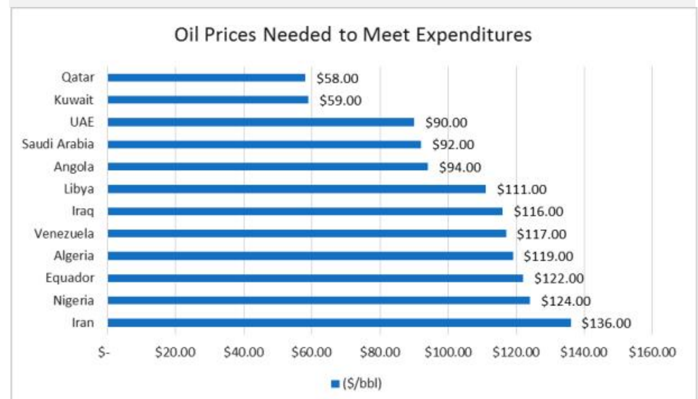
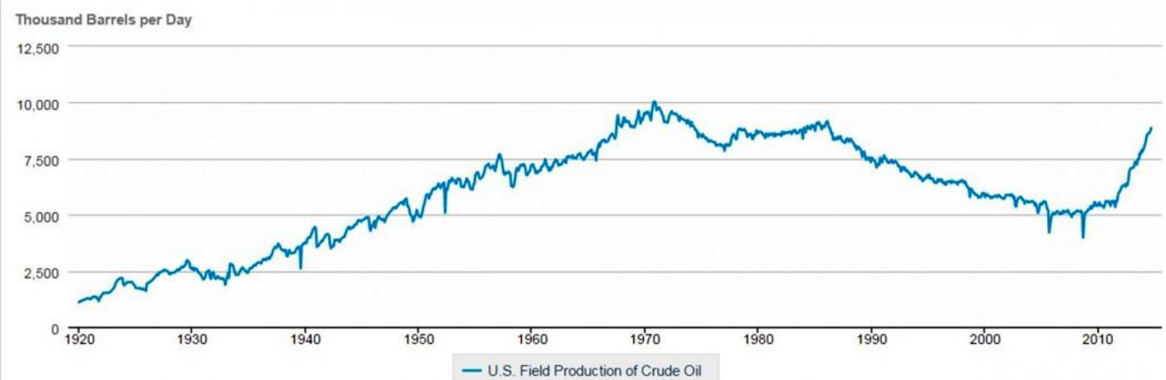


Chart 2
Source: US Energy Information Administration



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