Laurus
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"Cry baby cry, Make your mother sigh, She's old enough to know better. So cry baby cry."

- from the song, Cry Baby Cry by The Beatles

In a stunning announcement November 1st, Pengrowth Energy Corp. announced its sale to Cona Resources Ltd. for five cents a share and assumption of company debt. Once a $7.2 billion oil and gas exploration company, Pengrowth Energy has lost almost 99.6% of their equity value in the past six years.

In his apologetic comment to shareholders, the Pengrowth CEO stated the Company was unable to raise capital to fund its heavy oil business in the face of lacklustre oil pricing and increased political and regulatory uncertainty.

Canadians should view the Pengrowth Energy Corp. announcement as a warning flare. To re-phrase comments by Mark Carney (previous Governor, Bank of England) in a recent speech, global investors are avoiding oil and pipeline projects as the world slowly begins to price in the risk of moving towards a low-carbon future. This should be a sobering wake-up call for Canadians as much of our economy is based on resources and resource infrastructure.

According to a recent piece by Mac Van Wielingen, founder and previous CEO and Chairman of ARC Resources, the energy sector is the largest sub-sector of the Canadian economy, responsible for over $200 billion (about 10%) of Canada's GDP. He contends that the growth in US oil production over the past five years, combined with the failure of high-profile pipeline projects to allow Canadian resources to reach foreign markets, has resulted in the diminishment of Canada's global leadership with enormous financial and social costs.

Despite the very long transition to alternative fuels, global energy demand continues to increase according to the IEA 2018 Global Energy and CO2 Status Report released on March 26, 2019. But despite this mounting evidence of continued demand, companies have slashed production capital expenditures and investors remain extremely bearish towards oil-related equities

Last year, Los Angeles-based Capital Group wrote a letter to the Canadian Prime Minister on their US$30 billion investment in Canadian energy companies to explain why global investors are avoiding the Canadian energy sector.

"Market access is critical to an investment in a Canadian energy company and if that continues to be under threat, global investors will seek opportunities elsewhere and Canadian companies will be further impaired. Increasingly, investors are questioning the merits of investing in Canadian energy and with that, Canadian companies will struggle to access capital, create jobs, develop resources and provide a significant revenue stream for the country."

With little capital available for increases to production, sales similar to Pengrowth Energy will likely continue to happen. The recent attacks in Saudi Arabia created a short term, but unsustainable, catalyst as oil prices spiked on the expectation of a supply reduction. But it will require a prolonged impetus to draw capital flows back into the energy market.

Yet it would be difficult to find a Canadian equity portfolio without at least a sprinkling of energy producers. Their valuations are sinfully low. Companies like Whitecap Resources – a stock presently trading around $4.00 (at this writing) representing a valuation of 2.6x cash flow but has produced $0.68 of free cash flow over the past four quarters for a free cash flow yield of 17% – is difficult to pass up as an opportunistic investment.

We believe two things are going happen to oil-related equities in the next few years. Either they will close the massive gaps in their valuations by surging in price, or the industry will go through a period of massive consolidation. In the meantime, investors should be careful to ensure any capital allocated to these businesses is well secured by the underlying profitability.