A Dive into the Energy Sector: Part 1

– Danke Wang, Portfolio Manager

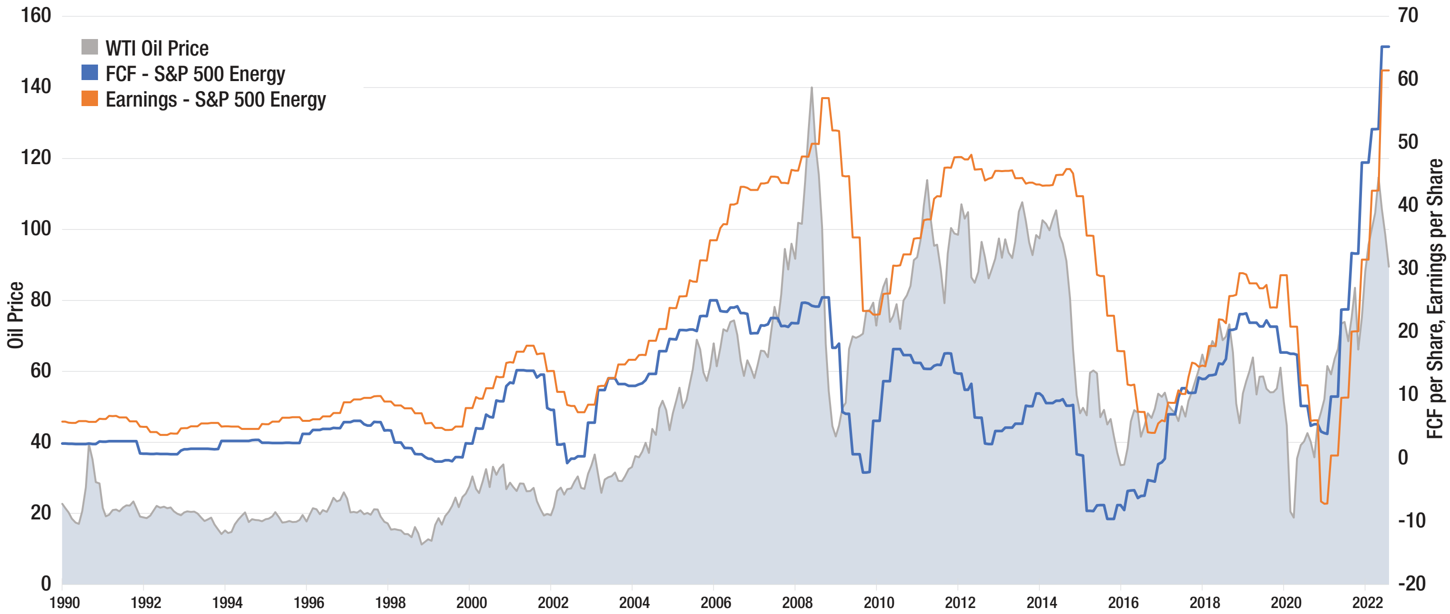
Though inflation eased slightly for the second month in a row, people in the US are still seeing rising prices everywhere. The August CPI (Consumer Price Index) year over year number came in at 8.3%, which was higher than expected.

As a major economic input, crude oil saw its price reach its highest level in a decade. Unsurprisingly, higher crude oil prices led to record earnings and free cash flow (FCF) levels in the Energy sector, particularly from oil companies.

Key Takeaways

1. Energy companies are focusing on free cash flow generation after experiencing roller coaster oil price volatility for nearly a decade.
2. Record high oil prices drove record earnings and free cash flow from the Energy sector.
3. Free cash flow yield is a more relevant valuation metric for energy companies.

S&P 500 Energy FCF Earnings vs Oil Price
as of 8/31/2022



Source: Bloomberg

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. YOU CANNOT INVEST IN AN INDEX.

Oil's Boom, Burst, and Boom Again

In 2022, world oil prices shot up above $100 for the first time since the oil collapse in 2014. As of 8/31/2022, the WTI (West Texas Intermediate) oil price was around $90 per barrel, while the Brent oil price was $96. The FCF per share from the S&P 500 Energy sector index grew by 1.7 times compared to a year ago, reaching the highest level since 1990, more than doubling the previous high from 2006 to 2008 before the shale boom began.

This isn't the first time we've seen a $100-oil-price era. From 2011 to the summer of 2014, oil prices remained remarkably steady at about $100-$110 per barrel, just as we observed in 2022. However, back then, FCF was scarce (see chart above).

The FCF-light period began with the shale revolution, which triggered a rush from investors.

2010 to 2014 was an era that featured explosive growth fueled by technological innovation and breakthroughs. Investors were living in a dream of a "New Oil Order" created by the U.S. shale revolution that they believed would reshape global energy markets (in retrospect, it did because the US is more energy independent). Shale producers spent every dollar earned and borrowed to drill new wells. They typically reinvested 120% to 130% of their operating cash flow in new production.

U.S. Field Production of Crude Oil Thousand Barrels per Day

as of 8/31/2022

Source: EIA

Between 2010 and 2015, US oil production grew at a rate never seen in history. With oil trading over $100 a barrel, investors rewarded oil companies for high production in the hope that they would make a profit in the future. In a way, investors treated Energy sector names as growth stocks like Technology names today (ironically, the Technology sector was out of favor for most of the time during this period).

This growth phase ended when OPEC flooded the market with crude oil at the end of 2014 —to halt the rapid growth in US oil production — which triggered the most significant price crash in a generation.

This was the start of a new norm in the oil industry. From 2015 to 2020, oil prices ranged from $50 to $60 most of the time, while US oil production continued to soar with heavy spending. According to Deloitte, the US shale industry registered net negative free cash flows of $300 billion, impaired more than $450 billion of invested capital, and saw more than 190 bankruptcies since 2010[1].

As a result, the "New Oil Order's" production growth failed to fuel the Energy sector's equity performance (below chart).

(1)https://www2.deloitte.com/us/en/pages/energy-and-resources/articles/covid-19-implications-for-us-shale-industry.html

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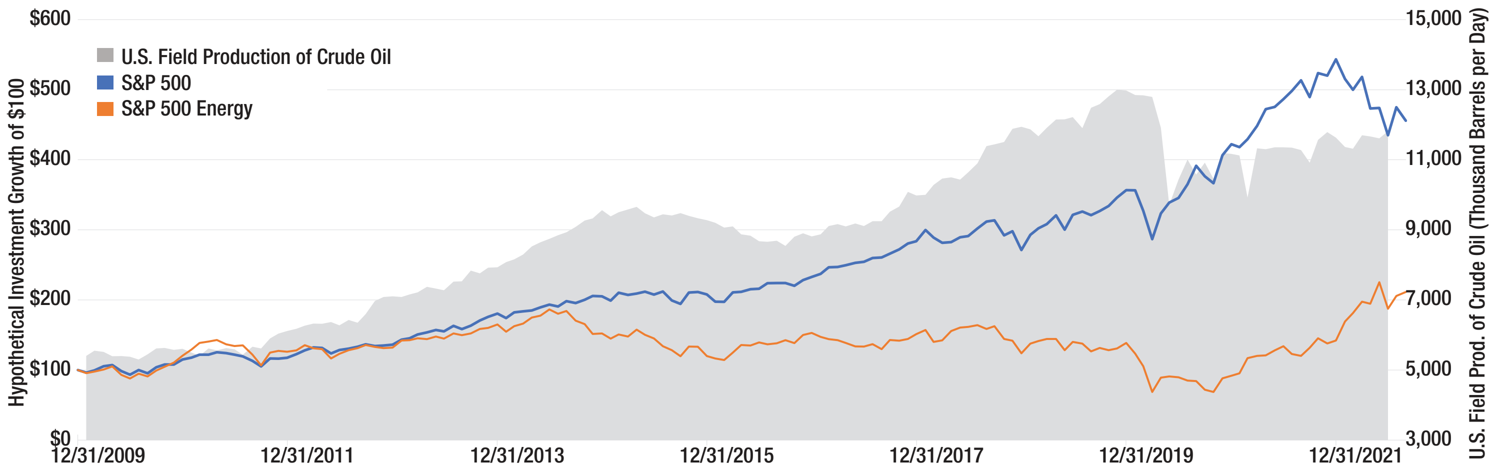
Stock Retun vs Oil Production
as of 8/31/22



Source: Bloomberg, EIA

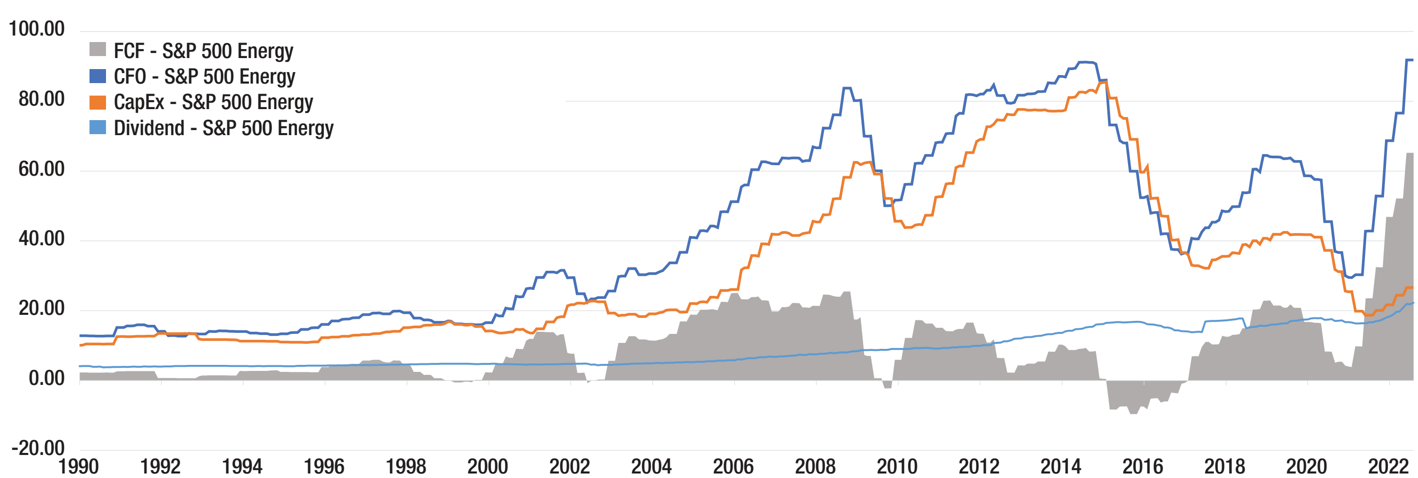
As the shale oil industry grew without making money (insufficient FCF), oil companies realized that the days of investing all their cash flow for maximum growth were gone. Instead, management teams began opting for more capital-disciplined business models. Besides reducing production costs through technological innovation (operators increased productivity while lowering the breakeven oil price to about $50 per barrel), managers of US E&P (exploration and production) firms suspended low-profit projects and reduced capital expenditure as they abandoned their growth-centric strategy.

Gradually, growth investors who historically invested in oil and gas became less interested in the industry. However, to attract value investors, oil companies put a greater focus on free cash flow generation, shareholder rewards and debt reduction.

Value Investing 101: Zero Cash Flow Is Zero Value

As seen in the chart below, the CapEx of the S&P 500 Energy sector index started to diverge from operating cash flow in 2017, elevating the FCF level above 0 and trending upward. Although the COVID-induced crash of oil prices almost derailed the industry's recovery, the strong rebound of commodity prices pulled the sector's FCF up to record levels in 2021 and 2022.

S&P 500 Energy
as of 8/31/2022



Source: Bloomberg

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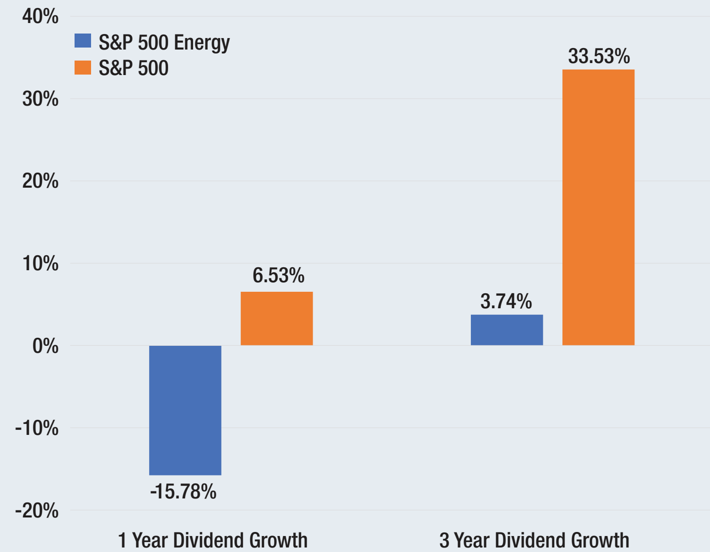
Value investors care a lot about dividends, and a lack of FCF might put dividends at risk.

This is precisely what happened during the shale boom when there was a large gap between FCF and dividends.

Source: Bloomberg
Dividends are not guaranteed.

Dividend Growth Energy vs S&P 500
as of 12/31/2016

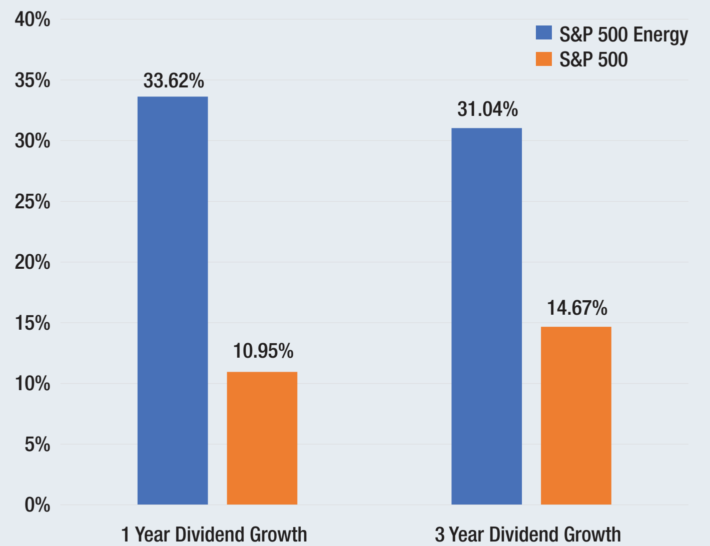


But following the recovery of FCF positions, energy companies found plenty of room for dividend increases and share buybacks.

And in recent years, the sector has seen a rush of companies initiating dividends and dividend payers sharply boosting their payouts.

Source: Bloomberg
Dividends are not guaranteed.

Dividend Growth Energy vs S&P 500
as of 8/31/2022



For the Energy sector, in a low-growth environment with volatile commodity prices driven by supply and demand, a focus on sustainable free cash flow is essential in establishing investors' confidence in how value can be defined and whether value can be created, especially when growth is unnecessary due to an oversupplied market.

This means FCF Yield is becoming a more relevant valuation metric for energy companies.

Empirically, energy stocks with the highest FCF Yield have outperformed the market by 1% a year over the long term. Yet recently, high FCF yield energy stocks are displaying a more significant advantage over the market, outperforming it by 21% per year since the start of 2020.

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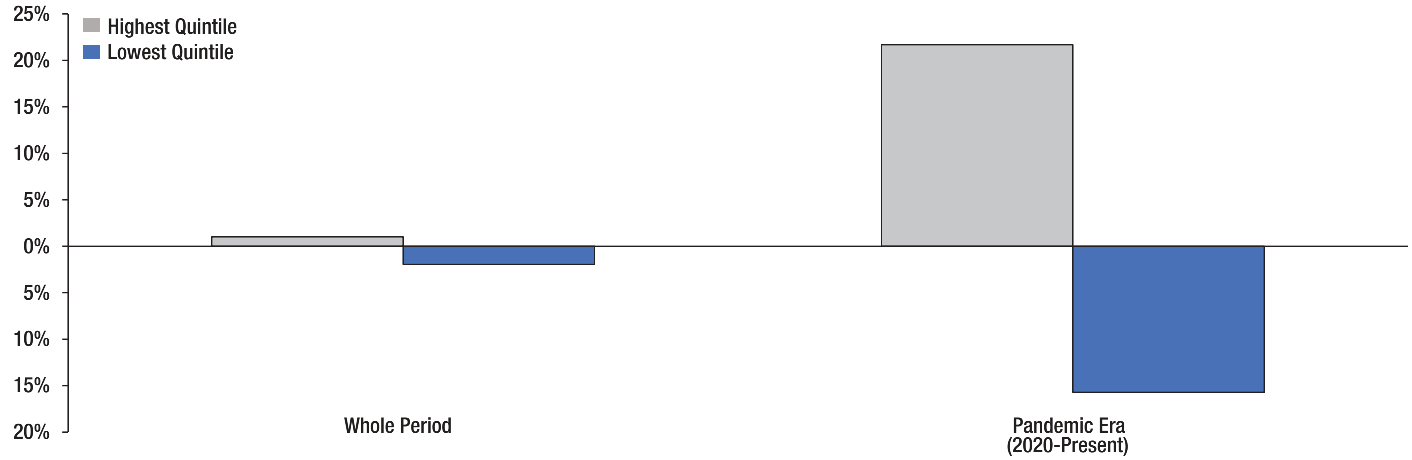
Large-Cap Energy Stocks Relative Returns to the Highest and Lowest Quintiles of Free Cash Flow Yield
Monthly Data Compounded to Annual Periods 1952 through Q2-2022



The Pacer US Cash Cows 100 ETF (COWZ) invests in the top 100 highest Free Cash Flow Yielding companies within the Russell 1000. The portfolio has more than a 25% weight in the Energy sector, the fund's top exposure. Among the energy companies, most of them are oil and gas producers.

Such overweighting reflects the oil sector's evolution and development over time and investors' current focus on free cash flow generation. By screening for energy stocks with a high free cash flow yield, we can identify where free cash flow is generated and where such profitability is undervalued.

PACER US
CASH COWS 100
ETF
COWZ

Pacer US Cash Cows 100 ETF

Is a strategy driven exchange traded fund that aims to provide capital appreciation over time by screening the Russell 1000 for the top 100 companies based on free cash flow yield.

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The Pacer US Cash Cows 100 Index was released on 12/8/16.
Free Cash Flow (FCF): A company's cash flow from operations minus capital expenditures (expenses, interest, taxes, and longterm investments)
Enterprise Value (EV): A company's market capitalization adjusted to eliminate any capital structure bias (i.e. by adding debt and subtracting cash or cash equivalents)
Free Cash Flow Yield (FCF/EV): Measures a company's total free cash flow relative to its enterprise value. This is an internal statistic and does not constitute investor yield.
Forward P/E: Market Price per Share / next 12 month earnings per share
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