

Not your parents' energy sector

February 2024

In Newton's view, changes in the energy sector could unlock value for investors.

Highlights

- With large energy companies focused more on shareholder value, oil and gas supply is likely to be constrained.
- We believe the shift toward more sustainable energy sources and technologies should support energy demand for oil and gas in the short-to-medium term.
- In our view, energy companies' focus on shareholder value and dwindling oil and gas supply could unlock value for investors.

Over the last few years, investors have taken a renewed interest in the energy sector. Some are looking for inflation protection, others are chasing returns, but most are seeking to capitalize on investments tied to longer-term structural themes like renewable energy, the energy transition, and carbon-emission reduction. Electric vehicles, energy storage, energy efficiency and smart grids are just a few focus areas as investors look to the future of transportation and power generation.

While there are a number of attractive investment opportunities related to these themes, we think the focus on next-generation power has largely overshadowed the structural change that has occurred across the broader oil and gas industry. For this reason, we think investors should consider an allocation to take advantage of both secular and structural tailwinds.

Value over volume

While we believe that many traditional energy companies will be the primary beneficiaries of the energy transition in the near term in view of the requirement for 'bridge' fuels ('cleaner' fossil fuels that can be used while renewable energy sources are developed), we think there is reason to consider them for the medium to longer term as well.

We think the energy-transition theme has overshadowed the structural change that has occurred among many large energy companies: they have become more disciplined with their capital. In the past, oil and gas companies would take \$1 out of the ground and invest \$1.50 (via leverage) back into the ground to either maintain or increase production levels. After years of lackluster returns and pushback from investors, as well as many companies seeing the 'writing on the wall' with regard to sustainable or renewable energy, many large energy companies have now adjusted their focus. Today, instead of reinvesting every dollar and then some in production, many public oil companies are using their proceeds to clean up their balance sheets by paying down debt, investing in their own renewables businesses, and returning more value to stakeholders in the form of higher dividends and share buybacks.

Economics 101: Less supply has what impact on price?

With large energy companies focused more on shareholder value, improved balance sheet health and renewables rather than traditional production, oil and gas supply could be constrained. This is one of the key reasons we believe we are entering a long-term commodity bull market.

Over shorter time periods, oil and gas markets tend to trade off demand sentiment. However, forecasting demand to estimate future prices has proven difficult over the longer term. Investors also use proxies such as GDP growth and other economic indicators to gauge demand, so if growth slows, demand is expected to decline as well.

In our view, supply is the key determinant of price changes over time and is easier to forecast. Our investment professionals communicate regularly with oil companies to learn how much each company is able to supply over the short to medium term. As noted above, over the last ten years energy companies have reduced investment in production. The structural deficit in investment and supply constraints means that even if oil and gas prices trend higher, energy companies are not able to quickly adjust supply levels.

Conclusion

There has been a broad shift toward more sustainable and environmentally friendly energy sources and technologies, yet these changes have, to date, had minimal impact on the demand for oil and gas. As populations and economies grow, they will require and demand reliable, affordable energy. Oil and natural gas are likely to comprise a significant share of the energy mix for many years to come, partly because of how they combine affordability, energy density and security of supply. We believe that these market fundamentals, the new incentive paradigm for energy companies, and dwindling oil and gas supply, can unlock value for investors.

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