Laketon Canadian Growth Equity

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Milos: Hello and welcome! My name is Milos Kostich and as VP Sales, Strategic Alliances here at Laketon Investments, I thank you for tuning in. Today's discussion deals with the North American Oil and Natural gas industry, an industry that accounts for a significant portion of the overall value of the S&P/TSX and one that makes significant contributions to the economies of both Canada and the United States.

Energy is the driving force behind any vibrant, growing economy, and it is therefore important to understand the underlying issues and challenges that face the oil and gas industry today and in the years ahead.

It is my pleasure today to have with me Ben Fawcett, VP and portfolio manager and a member of the Canadian Equity Team at Laketon. Ben focuses on the commodities sector specifically and as such is able to provide listeners with a keen sense of what the issues truly are when looking at Oil and Gas in particular. Welcome Ben!

Ben: Thanks Milos, good to be back.

Milos: When investors and the general public talk about the North American Oil and Gas industry they tend to think of the 2 underlying components as one entity. There are certainly different aspects to both the supply and demand variables within the Nat Gas space as well as the oil space. Can you give the listeners a sense of what really drives demand in these 2 areas and how is supply affected as a result.

Ben: Ok. To put it simply, supply/demand drivers for oil and natural gas do differ greatly in the North American market – that's why you often see them trade apart so much.

I can give an example of current spread between oil and gas prices.

To do this, keep in mind that on an energy equivalency basis it takes about 6.5 units of natural gas to equal 1 barrel of oil. So for example, nat gas currently trades at around $4. To put the nat gas price into oil terms you multiply the $4 by 6.5 this gives you a nat gas price of $26 a barrel.

On an energy equivalency basis nat gas is trading at $26 a barrel this compares to WTI which is now over $50. Obviously nat gas looks very cheap relative to oil at the moment, in fact the spread is currently at historically wide levels.

Why the difference?

Basically oil is a global commodity, where global supply and demand drivers set the price, while natural gas is more of a regional commodity. This is because oil can easily and cheaply, and cheaply is important, be transported anywhere on the planet. Natural gas on the other hand can also be shipped between continents through the use of LNG (liquefied natural gas) but the process is far more expensive and capital intensive, as a result only limited quantities are currently being transported.

So to sum up, oil ends up going to the person, wherever they are on the planet, who is willing the pay the most, while nat gas is stuck to the North American market only. Because the global supply and demand fundamentals for oil are stronger than those for the North American fundamentals for natural gas we see a huge difference in their prices.

Milos: Looking at Natural Gas specifically, much has happened, and is happening within this subset of the energy sector. Ben, could you comment on the current dynamics of the Natural Gas Industry within North America, and perhaps discuss the role that Liquefied Natural Gas or as you call it LNG plays on this continent.

Ben: Sure. As I just mentioned Natural gas is currently trading at a large, almost historically wide discount to the oil price. Why is this? The obvious answer might be that North America is clearly in a deep recession; therefore demand is down, end of story.

However, there is more to the story.

First, I will just go back and look at the demand case, how much is demand down due to this recession.

The magnitude of the decline in demand, about 3%, is much smaller than one might expect. This is because Nat gas demand is split 3 ways between household heating, power generation and industrial use.

Historically household heating demand has remained stable regardless of the state of the economy. And for a variety of reasons power generation and industrial demand have not declined terribly.

Bottom line weak demand does not justify the current $4 nat gas.

The real problem relies with supply, and more specifically technology and the high nat gas prices that we've seen over the last couple of years.

For starters, over the last decade North American nat gas production has been in a slow decline, because as the most prolific wells were tapped, drillers increasingly had to focus on the remaining less prolific wells, basically the dregs so to speak. So two years ago the North American nat gas supply situation was starting to look very dire.

However, last year something changed and nat gas production actually increased almost 7%, this is a huge jump.

This happened for two reasons:

First, the high nat gas prices we have seen over the last couple years have unsurprisingly stimulated increased drilling levels through increased investment.

The second, and more important factor however, is that new drilling technologies have open up massive new natural gas resources that were previously considered unrecoverable.

The technology consists of horizontal drilling and packers plus fracturing techniques.

Let me explain the two:

Starting with horizontal drilling. Drillers can now drill down vertically to the nat gas seam and then drill horizontally so that the profile of the well would look like the shape of a upper case L. What this does is dramatically increase the proportion of the well that is exposed to the gas reservoir.

But that's only the start, next Packers Plus and other fracturing technologies are used to fracture the rock around the horizontal well – this once again dramatically increases the surface area of well contact to gas reservoir contact

Without getting too technical, the result of all this is that huge new reserves of nat gas that were in rock previously considered too dense to let gas flow, have suddenly become available. The result is suddenly north America has gone from rapidly depleting reservoirs to huge reserve growth.

So to put it all together, demand is down a bit due to the recession and supply is up a lot due to new technology. The result is that the north American nat gas market is currently oversupplied and inventories are rising quickly, and I expect them to over the summer.

Adding to this problem is that nat gas inventories are finite and when the storage is full, generally sometime in September you literally can't give the stuff away and who knows where the price goes.

If this sounds bad it could actually get worse. The global slowdown has resulted in the collapse of global natural gas prices and as a result there is a good chance that unwanted cargoes of LNG will be destined for the North American market this summer.

So, what does this mean for nat gas pricing? It comes as no surprise that nat gas prices are likely to be messy over the next few months, BUT. on the brighter side, I think the street has largely recognized this fact and it is probably priced into equities. This potentially provides an opportunity to own nat gas stocks as prices start to recover, later in the summer or sometime in the fall. However, I don't see $15 gas anywhere on the horizon, $8 later in the year is quite possible.

Milos: Much has been said about the global economic slowdown and the effects on oil demand as a result. We have seen a variety of oil sands projects and the like put on hold or shelved here in Canada for the near future. Ben, do you believe that we are set to see prolonged oil price depression and substantial reductions in exploration, or are we going to see a return to the past boom phase in relatively short order?

Ben: Milos**,** when it comes to financials, or for that matter just about any other sector I think it's going to be a very long time before we see anything like the previous boom. The reality is that we should not be looking to get back at the boom levels, but we should be looking towards any sort of improvement, even though the economy is likely to stay weak for some time.

That said, I think some of the commodities, and in particular Energy, will be the exception to this and we could see ourselves back at the old peak within the next 2 years.

Here's our reasoning:

First, let me note that while I don't think the world is running out of oil at any time soon, oil will have to remain well above $60 in the medium to long term.

If we go back to the 1970's oil crisis most of the worlds oil bearing sedimentary basins were drilled up, and with that drilling went the most accessible and cheapest oil reserves on the planet

With a few exceptions, most new oil discoveries of any size, be they deep water Brazil or Gulf of Mexico or oil sands in Alberta require $50+ oil to make them work.   With old cheap wells in decline and new production being very expensive we need to see several hundred billion dollars of investment in new production over the next few years. Quite simply this investment isn't going to happen with oil sitting at the currently levels.

We are already seeing significant, even alarming, declines in non-opec oil production, and this problem will only be compounded once the global economy starts to rebound and demand picks up.

To sum up, the longer oil stays at current levels the sharper and more violent the inevitable rise when the economy turns.

Milos: There has been much discussion regarding the recent proposed merger of Suncor and PetroCanada, potentially creating the second largest company in Canada, second to the Royal Bank in overall size. Could you comment on Why this merger and Why now and what the ramifications are for the 2 companies involved and for shareholders specifically.

Ben: To the why of this merger, initially there was a lot of speculation that Suncor made the bid for Petro Canada as a poison pill to thwart a bid from an international oil co such as BP or TOTAL.

However, in reality the reason is far more straightforward.

Suncor has an aggressive growth program investing billions of dollars into the oil sands with the goal of eventually quadrupling its production. To do this Suncor has spent the last decade building a top notch team. However, with the low oil prices they recently had to shelve all development projects in order to save cash and the result of this has been to put the company at significant risk of losing this extensive and experienced team to many competitors out there.

By buying Petro-Can, Suncor not only makes an accretive acquisition but also allows it to restart its huge pipeline of development projects and keep this big experienced team.

So how to proceed from here, for the record we have a small overweight in Suncor and more signification position in Petro-Can.

First, we don't think anyone else will bid for Petro-Can and Suncor won't have to raise its bid. Petro Can is currently trading at an 8% discount to the implied takeout price – or about 20% annualized discount – this is significant and higher than you would usually expect in such a situation.

There are three reasons why the spread is larger than usual. First there are concerns the government might stop the deal, second, the risk of an outsider making a bid for Suncor could break the deal, and third Suncor might not be able to get the 2/3rd share holder vote that it needs. While we think there is limited risk of any of these outcomes playing out, we are paring back our Petro-Can overweight as the impact of the deal breaking up, while having a low probability would be significant , Petro-Can's share price could go down 20%.

Milos: Given our discussion today regarding the oil and gas industry, how has the Canadian equity team positioned this particular sector within the Laketon Canadian Equity Fund?

Ben: Well, we are secular bulls on the energy story. We are neither over or underweight the group materially. As our philosophy is to focus on picking the best stocks and not making sector or macro-calls.

For the moment we are mainly focused on large, liquid, quality names, as there is still likely to be a lot of volatility in the group, and the credit markets are still a bit sticky.

Two high quality holdings of ours, with top notch resources and excellent management teams are Encana and Canadian Natural Resources.

Milos: Well, thank you Ben for sharing your comments and perspective with our listeners today. Always a pleasure.

I hope that you have all found today's discussions informative, useful and timely. These continuing audio commentaries serve as an effective way of communicating Laketon's portfolio manager views and perspectives on a variety of topics as well as a timely source of information for advisors and clients alike.

I encourage you to log onto our website at www.laketon.com for this and other commentaries in addition to quarterly fund information.

Thanks again for tuning in.