Energy Sector Report

Total Revenue (Bil)	Market Cap (Bil)	Number of Companies	Total Employees	Sector Price/Fair Value	Universe Price/Fair Value
3,922 USD	3,934 USD	116	2,982,354	0.90	1.05

Sector Update

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Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.

Industry Price/Fair Value is the median value of the companies covered by the Morningstar Equity Analysts.

- Energy stocks are modestly undervalued currently, thanks to the recent slide in oil prices in the United States and abroad on expectations of weaker global demand and robust North American supply growth.

- Drilling efficiencies continue to accrue to U.S. E&Ps, where oil and gas production growth remains strong despite moderating prices recently.

- Despite softening demand, surging production, and weakening prices, we continue to see longterm benchmark oil prices around $90 per barrel for WTI and $100 per barrel for Brent, and still expect long-term gas prices in the United States to strengthen above $5/mcf.

- This quarter, we examine prospects for Canadian energy, where insufficient pipeline capacity limits access to export markets.

There are four key markets for Canadian oil: domestic, the U.S. Gulf Coast and Mid-Continent, Canada's east coast for export, and Canada's west coast for export. Reaching these markets will require a combination of crude by pipeline and rail with Canada's coastal markets expected to serve as critical ports for tankers to transport oil to global markets (including the U.S. Gulf); this is largely a result of a lack of refining capacity in Canadian coastal markets for large volumes of heavy crude oil.

Taking into account the current and proposed pipeline system in western Canada, we believe the region will remain deficient in pipeline takeaway capacity well into the future. As rail volumes increase from 500 mbpd in 2015 to 850 mbpd in 2017—rail capacity should breach 1 million bpd by the end of 2014—before softening as oil sands growth reduces.

As a result of the need for Canadian producers to rely on rail for the long term, we expect Canadian oil differentials to reflect the marginal cost of transportation. Canadian light differentials (versus Brent) are expected to widen from historic CAD 2 per barrel to CAD 17/bbl–CAD 21/bbl, with heavy differentials (versus Brent) widening from CAD 19/bbl to CAD 23/bbl–CAD 29/bbl. In particular, Canadian light is at risk of impairment if it is unable to access international markets. However, the ease for producers to export crude mitigates the risk. Heavy grades will find a near-term (2014–17) home in the Gulf Coast, with access to high netback international markets in 2018 as export pipelines to the west and east coasts come on line, mitigating the risk of heavy oil/oil sands impairment.

MEG Energy MEG stands alone in terms of its cash flow CAGR of 39%, which is a result of its long-term oil sands growth plans and market access strategy which relies on a combination of pipelines and rail. Its expected 10% increase in net asset value (CAGR) from 2012–18, is matched only by Canadian Natural Resources Ltd CNQ. This is partially a result of strong netbacks, 7%CAGR for MEG and 6% for CNRL. These improving metrics largely reflect MEG's marketing plans to move bitumen to markets with international pricing, while CNRL is boosted by alternative transportation plans, increasing volumes of upgraded bitumen (from its Horizon project) and improving natural gas prices. When we combine these peer-leading metrics with its best-inclass operating costs, MEG Energy remains on our Best Idea list.

Suncor SU remains a strong pick within the Canadian energy space, a result of its best-in-class Canadian refineries which are partly due to the physical integration of its upstream heavy oil assets with its downstream refineries. We believe Suncor should

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accelerate the development of its potential in situ oil sands projects, starting in 2018 and consider acquiring Apache's APA interest in the Kitimat LNG project. In addition, Suncor should halt its share buyback program and increase returns to shareholders through an annual special dividend. Depending on the outcome of Kitimat, this could support a CAD 7–9 per share increase in its fair value.

While we see opportunities within Alberta for our Canada-exposed midstream firms, Pembina PBA and Keyera KEY remain overvalued, and we continue to recommend caution and that investors should consider selling these stocks. We prefer the larger midstream providers with diverse growth profiles that include exposure to the key long-haul projects. This includes Enbridge ENB, TransCanada TRP, and Kinder Morgan KMI, with Enbridge and TransCanada more heavily levered to the continued production growth of Canadian oil. Nevertheless, we find the potential returns limited as all three of the long-haul exposed mid-stream providers are trading close to our fair value estimates and would advise clients to continue holding these stocks.

While MEG remains our Best Idea for our Canadian oil and gas coverage, we continue to see opportunities in the United States and abroad.