

The Investment Outlook for the Canadian and US Oil and Gas Sectors

Evidence from Financial Metrics

by Steven Globerman and Joel Emes

Canada's oil and gas industry has long been a driver of the country's economic growth. Hence, the outlook for the industry's future profitability is an important determinant of capital investment rates and employment trends for the industry and the country as a whole going forward. The substantial decline in the profitability of Canadian oil and gas companies post-2014 was unsurprisingly accompanied by a collapse of domestic investment in the oil and gas sector. In turn, the decline in profitability was linked to a precipitous decline in the price of crude oil, as well as disrupted shipments of crude oil owing to pipeline capacity constraints.

More recently, there has been a recovery in the price of crude oil produced in both Canada and the United States. However, while economic activity in the upstream segment—that is, the exploration and production segment—of the industry in the United States increased with a modest recovery in crude oil prices in 2017 and 2018, investment in Canada's upstream segment continued to decline. Survey evidence, as well as reports prepared by investment analysts and portfolio managers, suggest that an unfavourable business environment in Canada compared to the environment in the United States is the main factor contributing to a diversion of upstream oil and gas investments from Canada to the United States.

Investors' expectations of the future competitiveness of the Canadian business environment compared to that

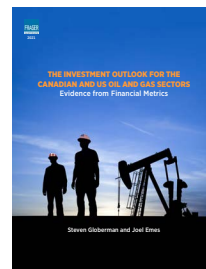
of the United States should therefore exert a strong influence on corporate investment in Canada's oil and gas sector. In turn, the expectations of investors, as expressed in the financial valuations they place on publicly traded Canadian oil and gas companies relative to their US-based counterparts, provide some insights into the likely long-run investment prospects for the oil and gas industry in Canada compared to the US oil and gas industry.

Financial valuation metrics are frequently employed to identify investors' expectations about the future profitability of companies. Specifically, the market price of a company's publicly traded shares relative to measures of a company's current economic performance such as earnings and revenues is taken to reflect investors' expectations of future profitability. This study reports and

evaluates recent financial valuation metrics for portfolios of Canadian and US oil and gas companies along with historical values of those metrics to identify whether relative assessments of investors in companies listed on the main stock exchanges in each country differ in recent years from those in earlier years. For the period from 2019 to 2021, the valuation metrics, on balance, suggest some improvement in the profitability outlook for Canadian oil and gas companies relative to their US counterparts. However, over the longer period from 2011 to 2020, there was a fairly consistent decline in the relative values of the various financial metrics for Canadian oil and gas companies. Hence, the relative improvement in the profit outlook for Canadian oil and gas companies is quite recent. Indeed, the improvement largely reflects the valuation metrics for 2021.

It is certainly possible that the outlook for a more restrictive regulatory regime surrounding oil and gas exploration and production under the Biden Administration in the United

States has, in the view of investors, shifted the relative competitive positions of the industries in Canada and the United States to be more favourable for Canada, on the margin. One must be cautious, however, in drawing strong conclusions from a single year's (2021) divergence from a decade-long pattern of valuation declines for Canadian oil and gas companies relative to their US counterparts. Investors in the North American energy sector will arguably continue to favour US-based investments if the regulatory and tax regimes in Canada are less favourable to investors than those in the United States.



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