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TSX Sector Strategy #8

July 4, 2005

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Raising 12-Month Target For Energy Group to 3250, Based on Average $65 WTI in 2006

Jeff Rubin and Peter Buchanan

Market Weight 24% **Recommended Weight 30%**

Summary

- Supply and demand developments point to a further tightening in crude markets. Production in Russia, source of 80% of the recent growth in non-OPEC output, has stalled in the last 8 months while an overdependence on a few geriatric fields creates downside risks for Saudi production.
- Oil prices will have to rise to an average $65 in 2006 to close a 2 million barrels per day supply and demand gap, which will increase to 9 million barrels by decade end.
- We have raised our 12-month ahead target for the TSX Energy group to 3250, given our latest oil and gas price projections, 25%–30% above today's level. At a near historical 5½ times projected 2005 cash flow, the energy sector still offers good value.
- Cash flow multiples should continue to expand as investors increasingly recognize the Canadian oil patch's strong drawing cards, including the unrivalled potential of the oil sands. Canada is also the only top tier reserve country relatively open to private foreign investment.

Key Indicators

	Latest (Jun.30)	2005	2006
WTI ($/bbl)	56.50	55	65
Natural Gas (Nymex, $/MMBtu)	7.03	7.50	8.25-8.50

	Latest	12-Month Target
TSX Energy Index	2504	3250
	2005	**2006**
Index Adjusted Cash Flow	450	560

Raising 12-Month Target For Energy Group to 3250 Based on Average $65 WTI in 2006

OPEC, its once vast spare capacity reduced to a mere million barrels of hard-to-process Saudi heavy crude, abandoned any pretext of taming oil prices in June, setting a crude pricing target that effectively just mimics the market. We've accordingly upgraded our already bullish call on the TSX Energy group, lifting our 12-month target for the index to 3250 from 2600. This reflects our belief that oil prices—still $30-$35 below the 1980s all-time highs in real terms—will climb appreciably further, as price-resilient global demand collides with accelerating depletion and a longer term drop in new mega project development. To capitalize on a 25-30% increase in asset values, we recommend that investors hold 30% of their Canadian equity portfolios in energy, six full points above benchmark, and a point over our earlier recommendation.

With a year-to-date return north of 30%, TSX energy stocks have comfortably outperformed their US and overseas peers this year. The unmatched growth potential of the oil sands and the Canadian industry's upstream focus and openness to investment, have been big pluses for the Canadian oil patch. Still trading at a measured 5½ times 2005 cash flow, Canadian oil and gas valuations are not expensive even after a 60% plus run-up since last June. Viewed from a historical perspective, the recent rally is only a fraction of the over 400% run-up in valuations sparked by a comparable rise in crude prices around the time of the Iranian Revolution in the late 1970s.

While oil prices are the main driver of the rally, Henry Hub gas prices have rebounded in the face of forecast hot weather and firming demand, providing additional cash flow support. Our forecast of an average wellhead WTI price of $65/bbl in 2006 implies, even with a substantial energy content discount, further upside to $8.25-$8.50 range for natural gas prices next year.

Supply Unlikely to Match Strong Underlying Demand Growth

Developments in the world's two largest producers—Russia and Saudi Arabia—are challenging long held market perceptions of a virtually limitless, highly elastic supply curve for conventional crude. Output in Russia, whose oil wells have provided 80% of the growth of non-OPEC supply in recent years, has stagnated in the last eight months (Chart 1).

That comes after a decade or more of rapid supply growth, that allowed the country to reclaim its Soviet-era mantle as the world's largest crude producer. While the Yukos affair may account for some of the deceleration, the downshift according to many observers reflects deeper problems. Impressive but essentially non-repeatable gains have come in many cases from simply reworking deposits in existing fields bypassed by Soviet-era managers. Even the International Energy Agency's forecast of 3-4% output growth in 2005, a third of the pace of recent years, looks increasingly unattainable as those benefits fade.

In Saudi Arabia, events are also challenging long-held market complacency about future crude supply. Three quarters of the country's oil production comes from five geriatric superfields, discovered for the most part in the 1940s and 1950s. Oil production in recent years has never exceeded its early 1980s peak of 10 million barrels per day (Chart 2). Optimism based on the past throttling up of Saudi oil output during the Gulf War also seems misplaced. The Saudis had massive spare capacity back then due to earlier production cuts, in sharp contrast to the present situation, where the only spare capacity is heavy oil.

Moreover, world demand for crude seems increasingly resilient to price rises, largely due to explosive rates of

Chart 1

Russia's Troubles Constrain Non-OPEC Supply

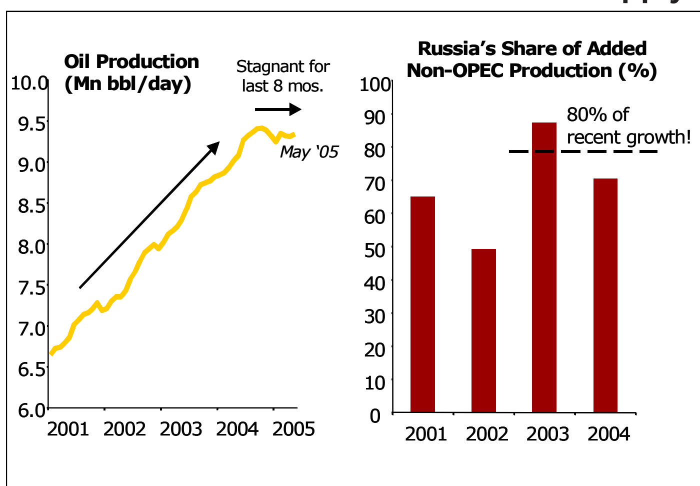
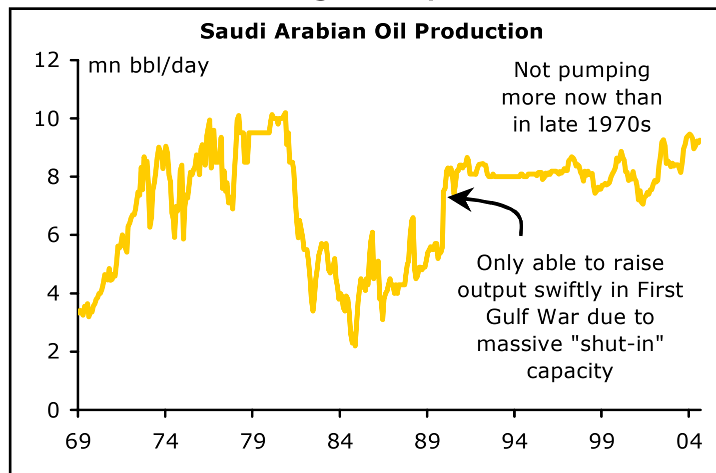


Chart 2

Saudi Arabia—Fading Oil Superstar?



growth in oil consumption in China. China's crude oil imports have risen at a near-20% year-on-year rate in the last three months. Buoyant demand from emerging markets like China and India should lift global oil demand by about 2.5% this year, two to three times the pace of the last 25 years.

While global demand has increased, depletion rates are rising worldwide, resulting in an inevitable decline in the productivity of existing oil fields. Depletion will accelerate in coming years, as oil production starts its relentless decline in a number of key producing countries such as Mexico and even parts of the Middle East. By the end of the decade annual depletion will have reached 1.6 million barrels a day.

What does all this imply for the supply outlook? And what wellhead price trajectory will be needed to keep strong underlying growth in demand within the confines of limited available supply?

New Mega-Project Activity To Decline After 2007

Updated estimates from the London-based Energy Institute indicate that new mega-project activity will add about 11 million barrels per day to global output through decade end. On a year-to-year basis, the level of additions rises gradually through 2007, declining notably thereafter (Chart 3). Subtracting our assumed level of depletion, that works out to net supply growth of about 4 million barrels per day over the next three years, lifting global production capacity to a peak of over 88 million barrels per day towards the end of the decade, or a 4 per cent rise from current levels.

At present growth rates, global demand should exceed maximum available supply by 1-2 million in the next couple of years, rising sharply to a good 9 million barrels by 2010. Using an estimate of 0.15 for the elasticity of global crude price demand (based on a weighting of US Department of Energy estimates for individual consuming regions), we estimate that crude prices will have to average $65 in 2006 to kill off growing excess demand, rising to just over $100/bbl by 2010 when some nine million barrels per day of crude demand must be eliminated by prices (Chart 4).

Investment Inflows & Oil Sands To Support Higher Multiple

This trajectory for prices, combined with normal levels of operating leverage, implies that the energy stock

Chart 3

Rising Depletion, Post-2007 Mega-Project Drop Further Limits Supply

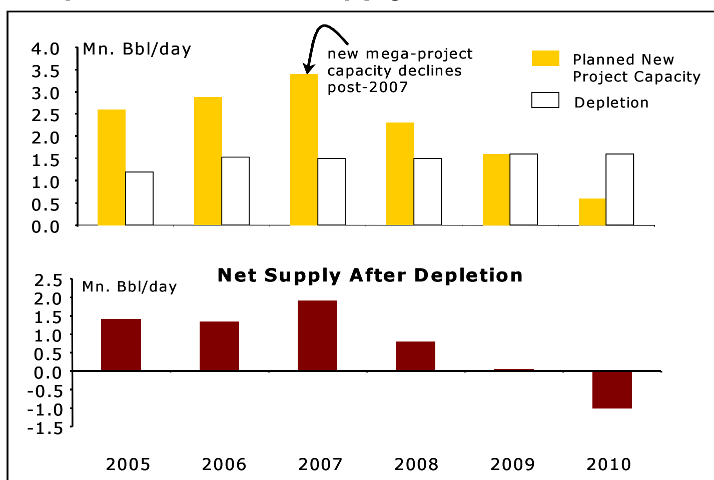


Chart 4

Further Sharp Prices Hikes Needed to Kill Demand

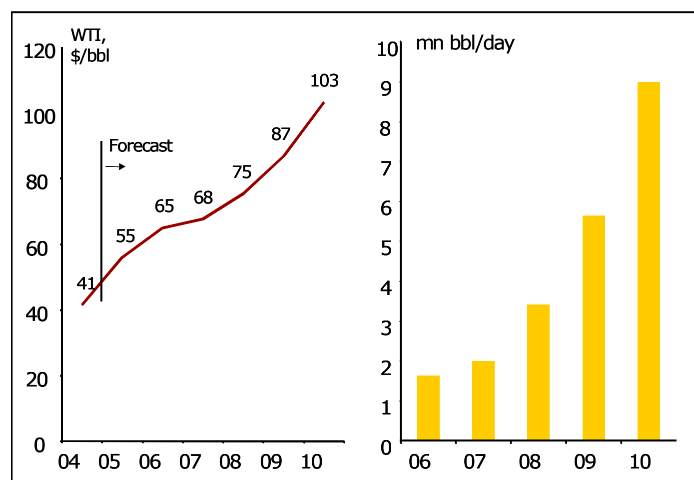


Chart 5

Higher Cash Flows & Multiple Creates Further Upside for Energy Stocks

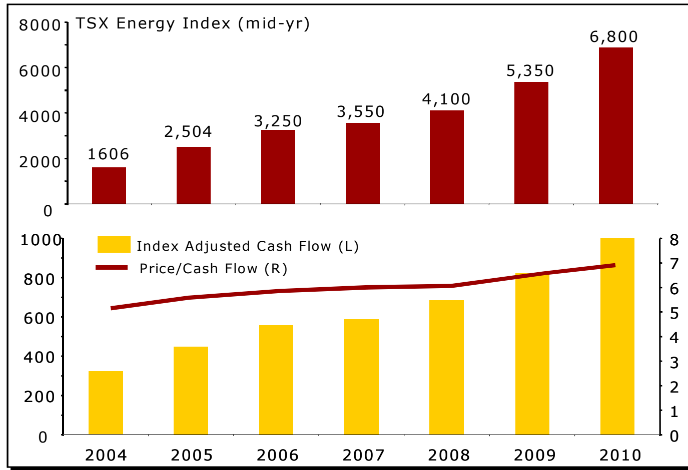
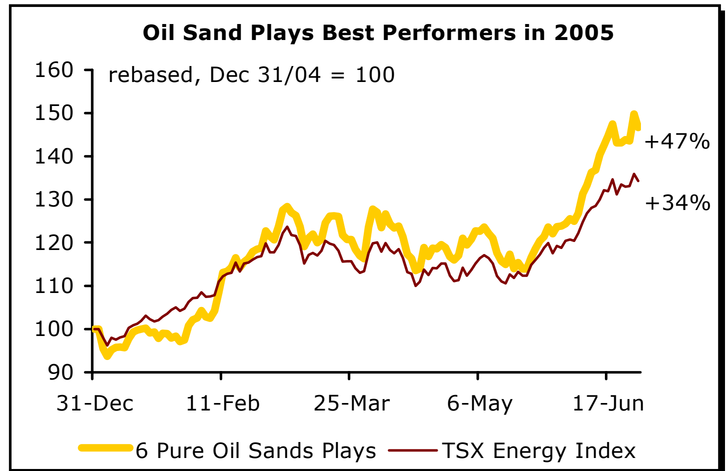


Chart 6

Investors Also Focusing on Oil Sands Potential

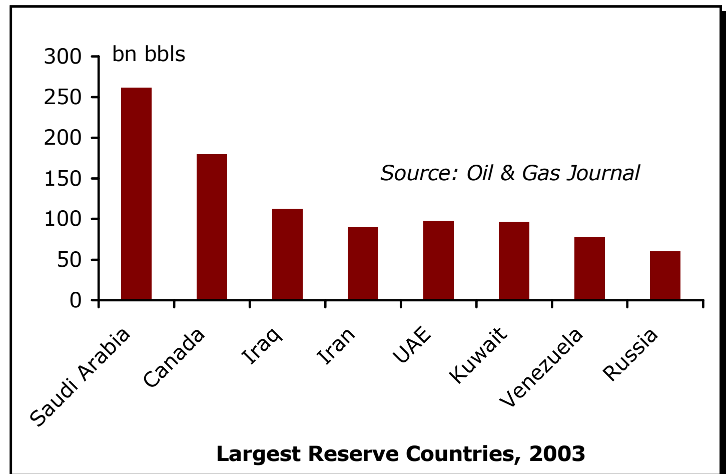


rally is far from mature. In terms of index adjusted cash flow, our projections point to an increase from around 300 in 2004 to 450 in 2005 and close to 560 in 2006. Allowing for a rise in the multiple to 5¾ (vs. a long term average of around 5½%) our cash flow forecast points to a fair value 12 months out for the energy index of 3250, 25-30% above current levels, suggesting the energy sector will continue to show market leadership (Chart 5). Pure oil sands plays have outperformed the overall TSX energy index by 10-15% so far this year (Chart 6). That segment of the industry adds a growth dimension to Canadian sector earnings not found elsewhere.

Ultimately, TSX energy valuations should rise much higher than 3250 down the road as markets not only recognize strong cash flow but more importantly, recognize the increasing scarcity value of Canadian oil sands assets and in particular, their relative attractiveness on a global scale. Canada stands alone among the eight largest oil reserve nations in offering offshore investors ready and transparent access to its oil sector, and in the process providing a hospitable M&A environment (Chart 7). That's all the more noteworthy when three quarters of global crude reserves today reside in countries with dominant state oil firms, curbing access by independent producers.

Chart 7

Canada Only One of Eight Top Reserve Nations Offering Access



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