

# Heavy Oil Emerging as Heavy Hitter

— DANIEL S. CHENG, CFA, PORTFOLIO MANAGER

If numbers speak louder than words, then the closing gap between heavy and light crude oil prices is delivering a clear message: Demand for heavy oil is rising and that's good news for some Canadian energy producers. Compare, for instance, the historical average price differential of 30.0% with a sampling of recent spreads: the record low of 7.0% in Q2 of 2009, 9.0% in Q1 of 2010, and 12.0% in Q2 of 2010. We think several drivers stand behind an emerging long-term trend of lower differentials and higher prices for heavy crude oil.

## Increased flow to U.S. markets:

- A large portion of heavy oil (approximately 4.3 mmb/d) is refined in the U.S. Gulf Coast Region. Canadian producers have long considered it a major target, but the lack of pipeline infrastructure has restricted access. This situation is changing as a number of new pipelines, with more under development, link domestic heavy oil producers to U.S. demand regions, increasing takeaway capacity for Canadian heavy crude.
- For example, TransCanada and Enbridge cross-border pipelines are already increasing capacity to ship Canadian heavy oil to the U.S. Gulf Coast. Several others from companies such as ExxonMobil, BP/Enbridge, Sunoco and Altex Energy are expected to come on-line in the next few years. Over the long term, we expect this additional shipping capacity will likely replace U.S. heavy oil imports from Mexico and Venezuela.

## Shifting supply sources:

- The U.S. market faces ongoing supply challenges as imports from Mexico, Venezuela and Saudi Arabia (Canada's traditional competitors) continue to fall due to natural field declines, political issues and increased domestic demand, respectively. Canadian producers stand to gain from this trend.

## Global demand for oil:

- Global demand for oil is expected to surpass 2008 peak levels, reaching a record high of 87.9 mmb/d by 2011 with the appetite for oil driven primarily by non-OECD countries such as China and India.
- Increasing difficulty in finding oil resources, as recently highlighted by the BP Macondo oil spill in the Gulf of Mexico and the potential tightening of offshore drilling are adding supply pressures.

## Our View

We would also note the delay of several oils sands projects in the past few years has reduced available supplies of heavy oil for the near term, leaving refineries with excess capacity to fill. All factors combined, we expect heavy oil differentials will remain tighter than historical levels, trending in the 15.0%-20.0% range over the next few years. In addition, the economics for heavy oil plays remain robust with many presenting a break-even oil price below \$30 per barrel versus current oil prices above \$80 per barrel.

Committing to this trend, we like firms such as royalty trust Baytex Energy Ltd. and small cap BlackPearl Resources Inc., which are 60.0% and 90.0% heavy oil weighted, respectively. Looking at large cap energy companies, we hold Canadian Natural Resources Limited, which has the highest heavy oil exposure at a weight of 35.0%. We expect these companies to continue experiencing stronger cash flow as a result of improved pricing and anticipate the good news of the last year will extend for the next two to three years. ■

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