NXG INVESTMENT MANAGEMENT
The Next Generation of Investment Management

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Is Energy's Outperformance Sustainable? Part 3

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Investors have been questioning whether the two-year trend of outperformance in the energy sector is nearing its end. Despite the highest average commodity price environment in a decade, capital investment remains at decade lows as the typical response to the supply 'price signal' breaks down.

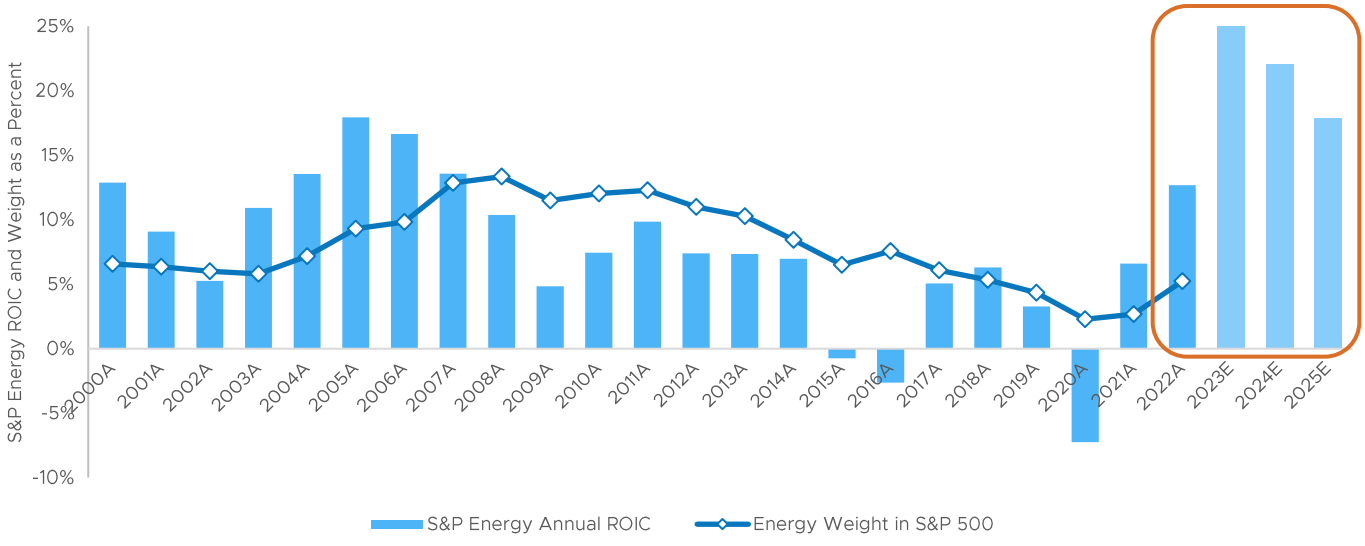
A variety of factors are inhibiting the sector's ability and/or willingness to respond to commodity price strength with higher levels of capital investment – a decade of low returns, lack of capital availability, low company valuations and correspondingly restructured management incentives.

NXG Investment Management is dedicated to providing Next Generation investment strategies to investors seeking long-term growth in companies focused on a clean and sustainable future, as well as traditional and transformational infrastructure companies.

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In this final installment of our three-part series, we explain why **we believe energy sector returns are poised to increase, potentially starting a beneficial cycle of more investment allocation, higher index weightings and an increase in valuation multiples.**

S&P Energy Annual Return on Invested Capital



Source: Bloomberg. Represents the median S&P Energy Sector GICS Level 1 Index return on invested capital. Forward estimates based on consensus data.

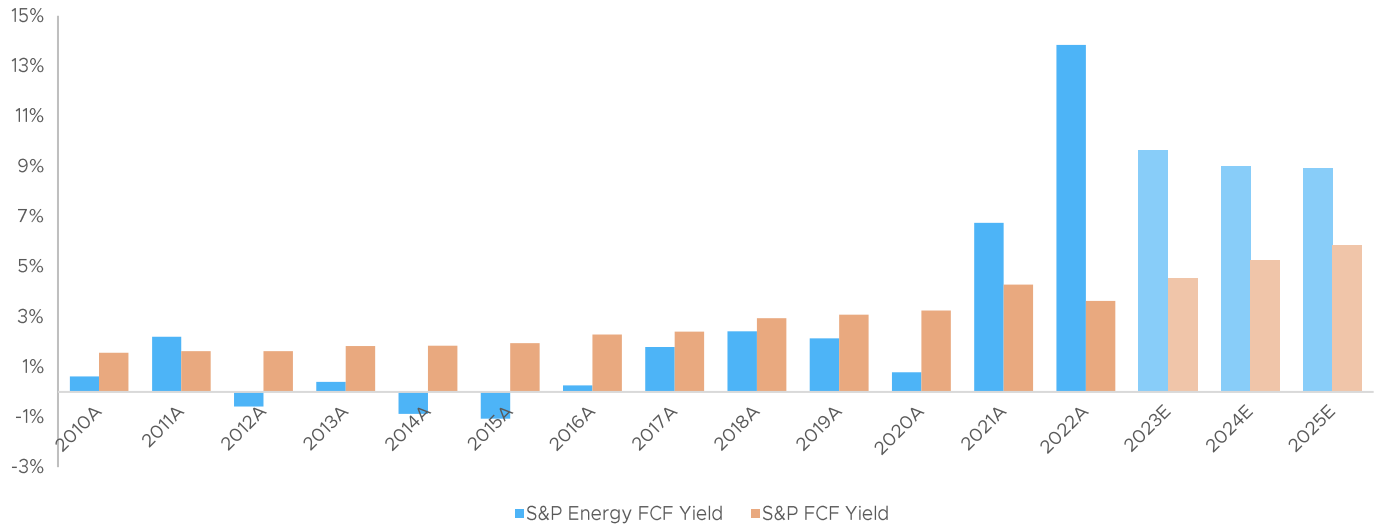
Part 3: Returns Poised to Increase

For the reasons detailed in "Part 1: Reduced Incentives to Invest" and "Part 2: Supply Pressures Increasing," we believe that persistent underinvestment in commodity production and infrastructure, a trend that began before the COVID-19 pandemic, may result in a multi-year recovery in energy and infrastructure assets.

Risks of a global recession and the attendant impact on global hydrocarbon demand, and relentless (albeit moderating) U.S. dollar strength – a headwind for all commodity prices – remain key offsets to our positive outlook. However, as capital spending decouples from commodity strength and remains constrained, free cash flow generation and returns on invested capital should increase.

According to consensus estimates, energy FCF yields are expected to average ~2x the broader market average in the coming years (see chart below).

Free Cash Flow Yields



Source: Bloomberg. Represents the median free cash flow yield for the S&P Energy Sector GICS Level 1 Index versus the S&P 500. Forward estimates based on consensus data.

Low returns over the last decade have kept capital out of the sector. **However, as industry returns rise with a continued corporate focus on return on invested capital, a virtuous cycle could be set in motion. This could lead to more investment allocation, higher index weightings and an increase in valuation multiples.**

Even if multiple expansion does not occur, we believe investors stand to benefit from the significant capital return provided by high free cash flow yields.

Finally, we also believe that concerns around energy security, exemplified by the Russian invasion of Ukraine, have highlighted the strategic value of energy-related assets.

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The S&P 500 Energy Sector GICS Level 1 Index (S5ENRS) Is a capitalization-weighted index of all companies in the S&P 500 that are classified as members of the GICS energy sector. The S&P 500 Index is widely regarded as a gauge of performance of large cap equities. Indices shown are provided for comparison purposes only. The indices are unmanaged, and returns do not reflect the impact of the advisory fees. It is not possible to invest directly in an index.