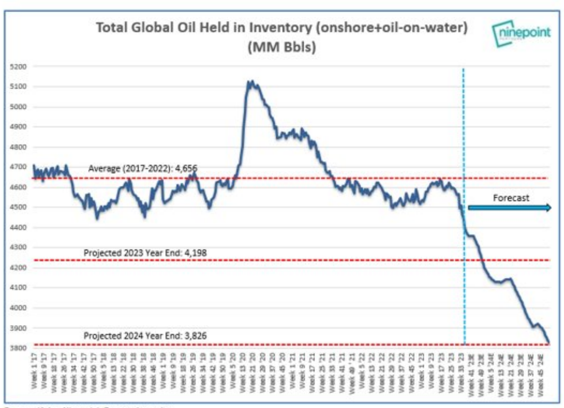
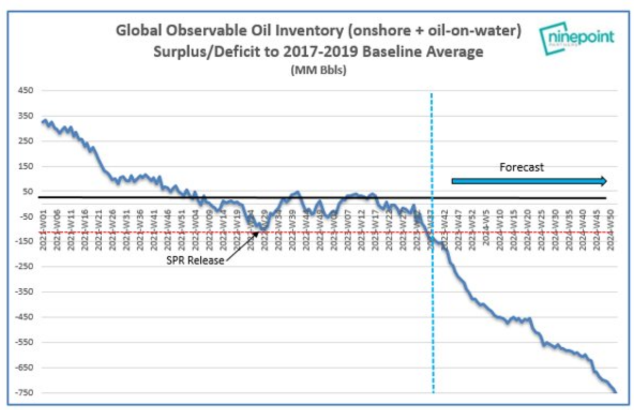
Oil Market Overview

Many have seen the recent vicious move in Oil prices since the SPR releases ended and may think they have missed the boat. That it's too late to buy energy stocks. However, lucky for the reader, this is one of the most hated rallies out there and the charts prove it. Not only are oil companies hated by the mainstream media, large college endowments, and the broader institutional public, but energy ranks as the cheapest sector of the S&P 500 relative to earnings .. and those earnings are somewhat depressed given the Strategic Midterm Release and the effects artificial supply had on earnings over the last year.

Many, such as the once hailed bearish Citi analyst Ed Morse, think the oil price is set to fall shortly after the recent rise, in an inverse V like shape, as they saw once the SPR took effect. However, we believe Oil is currently under supplied and experiencing a historic deficit which we expect to persist, despite mentions of increasing production, because consumption is also increasing and hitting new records even while much of the world is currently in recession, as foreign entities pull back on production to "stabilize prices" and domestic producers at an industry level are cautious around future investment, and inventories which are making new multi year lows continue to get drained as seen in the charts below.



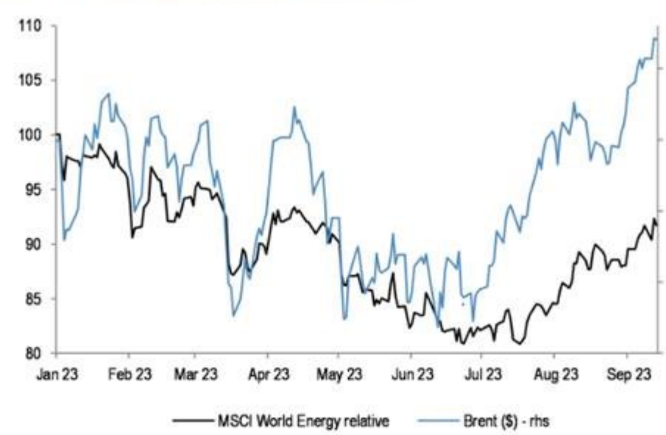
Source: Kpler, Ninepoint, Energy Aspects
Assumptions: 1MM Bbl/d Saudi additional cut effective through December, falls 0.25MM Bbl/d January through April, 2024 demand growth of 1.4MM Bbl/d, Iran supply +0.2MM Bbl/d 24/23, Non-OPEC production growth of 0.6MM Bbl/d (US = 0.3MM Bbl/d)



Source: Kpler, Energy Aspects, Ninepoint Partners
Assumptions: 1MM Bbl/d Saudi additional cut effective through December, falls 0.25MM Bbl/d January through April, 2024 demand growth of 1.4MM Bbl/d, Iran supply +0.2MM Bbl/d 24/23, Non-OPEC production growth of 0.6MM Bbl/d (US = 0.3MM Bbl/d)

Here is a chart that illustrates the "dramatic disconnect between oil and energy stocks" - Zerohedge. It's even worse for Devon Energy, which we think is wrong and sad, but good for us who want to accumulate. While some energy stocks are at all time highs, including $PBF which we have also written about, Devon Energy ($DVN) remains *well* off all time highs and *well* off the 2022 local

Figure 24: Energy sector relative performance vs oil price

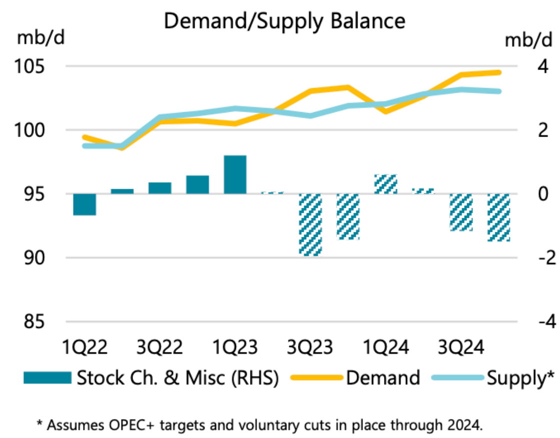


Source: Datastream

highs despite having a comfortably low breakeven cost of $40/barrel, being at *record production* and paying a fixed + variable dividend that correlates with the price of oil and production rates.

Broader oil market projections are very important for oil companies, but particularly for Devon given their dividend structure, and we remain bullish.

The third chart shows the market balance estimates from the EIA, who Saudi Arabia has recently criticized for being politically motivated, after they called for peak consumption in Oil in 2030. Please note that yesterday, just a few days after that report, the U.K delayed its ban on selling petroleum and diesel cars until 2035, from 2030.

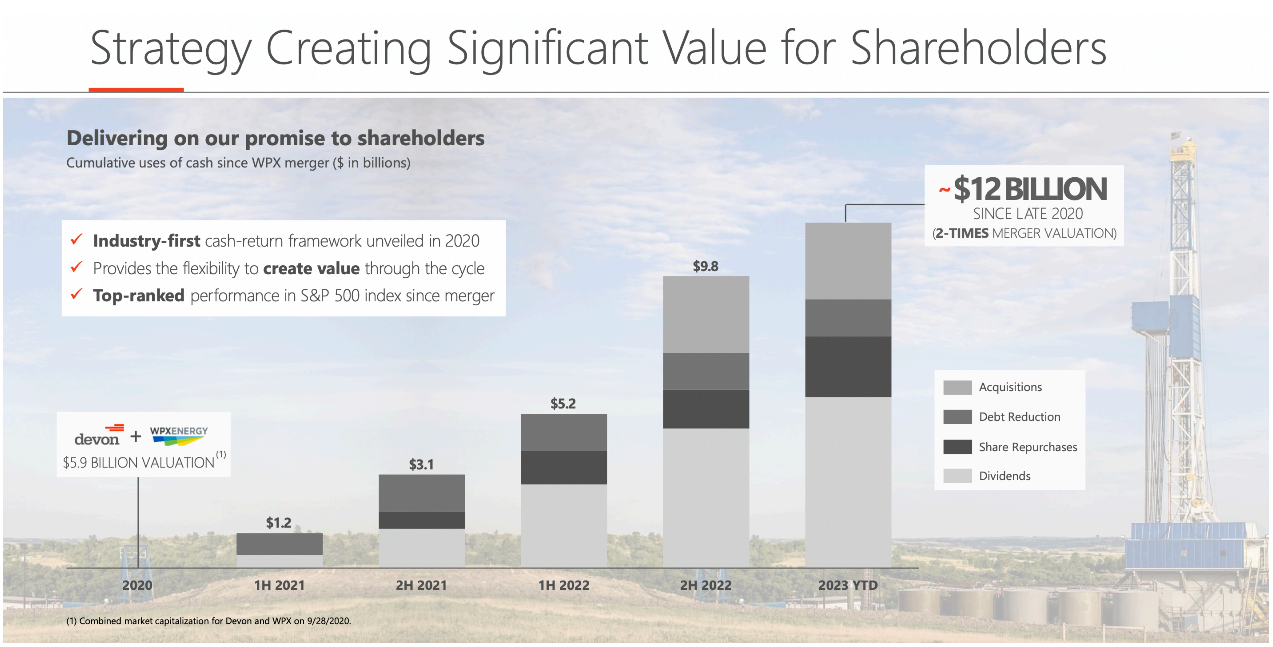


Many seem to expect a V shaped peak and valley in the price of oil, like what we saw last year once the SPR drains came online. However, we expect this bull market to be more in line with the previous bull markets since WWII, which are typically a multi-year structural bull market that can last up to a decade as seen in the 1970s and early to late 2000s, particularly given the unprecedented fear and negative sentiment around the space, vs what reality continues to deliver — record global consumption and a historic deficit. Even if oil prices stay flat at these levels, which we don't think they will because we think they will rise given the supply imbalance, Devon Energy's shareholder return program will yield fantastic results, as will be discussed.

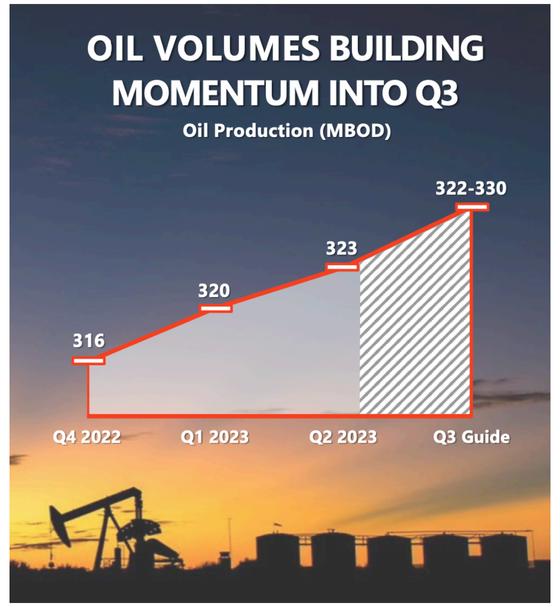
Devon Energy has a break even oil price of $40/barrel.

Devon's Shareholder Return Program

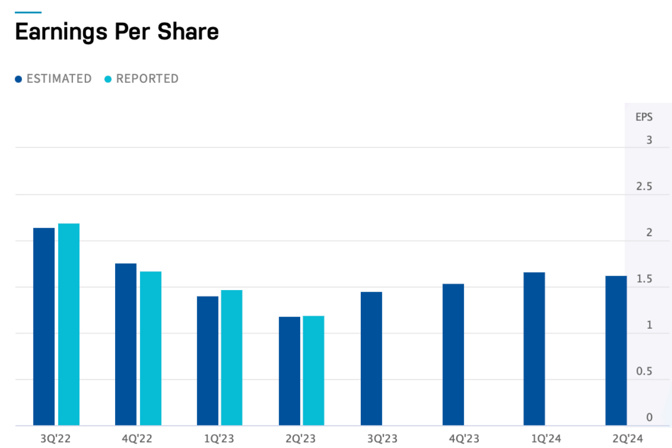
The following images are taken from Devon's Q2 2023 earnings presentation



The chart above illustrates the strength of Devon's shareholder return and investment programs this year despite the weaker oil prices, however it does include Q4 2022s $0.89 dividend, which was the lowest of 2022. Q4s oil prices, ranging from ~$70-$90, roughly mirror what we are experiencing in Q3 2023. The company repurchased roughly the same amount of stock in 2023 as of Q2s earnings release as they did in all of 2022.



In January 2023, despite oil prices on a consistent fall from their peak and a stock market near its lows, with many expecting a recession to ensue, Devon increased the fixed portion of their dividend by 11% to $0.20 per share. The variable side of the equation is often larger, and up to 50% of free cash flow is paid via the variable dividend per quarter. The total dividend reached a local low based on Q2 2023's numbers of $0.49 a share, down from a peak of $1.55 a share based on Q2 2022's numbers. A dividend number like that .. the same dividend that is capped out at 50% of free cash flow .. *before more buybacks* .. would give the stock a less than 10x trailing multiple. The S&P 500 has been around 20, and this isn't the training multiple, just the dividend.



To put the share buyback and production induced growth into context, Devon's calculated production per share growth is 9% Y/Y.

I'll attach the earnings per share expectations, but I would rely on them less the further out in time you go. I think oil can make new highs and stay in the $100+ range, which would lead to Devon's best earnings of the cycle, continuing to improve all else equal given the production growth and the share buybacks.

We expect that the current range of oil prices to establish a floor around this $85-$95 range, as the Iraqi minister claimed would be the case today. It's important to note that the last round of OPEC cuts were done by Russia and Saudi alone, who have implied there is additional room to take cuts further if needed. The statement of price level by the Iraqi minister provides some confidence for this stability.

In a market where stocks are broadly near historic valuations, it a relief to find one that actually makes sense as buying a statement of cash flows, not just an idea or the future, leaving us vulnerable to being disconnected to intrinsic value. Warren Buffet hasn't been buying much, but he's been buying in the oil space. Devon's story isn't just its dividend, but our projected annualized dividends alone would be well below the market earnings multiple. They also engage in share buybacks and other investment programs, such are acquiring midstream partners to cut costs in future years as oil consumption continues to grow.

I would argue Devon is also a growth business given production is up 8% Y/Y, 9% on a per share basis as of their last earnings call, and with this recent recovery in oil prices after the SPR finished its depletion, we should expect a return to earnings growth as well as big dividend increases.

Conclusion

It's important to note that volatility is par for the course in the oil industry. However, given the historic supply deficit discussed earlier in this analysis, we think Devon's

We buy a stock to acquire a productive asset that will generate cash for us and ultimately give us back more cash later.

In an environment where many stocks are attempting to reach for valuations they had in a world where interest rates were near 0%, money was being printed to the tune of trillions per year, and growth rates artificially high due to aggressive fiscal stimulus and a pandemic environment which benefited the largest tech companies in the world, the cheapest sector of the S&P 500 offers relief to the investor who simply wants to follow *classic investing principals*.

Devon Energy is the type of productive asset you can trust to provide you with the cash return you seek, and the value you need in your purchase. The company is engaging in a potent combination of growing production when many are hesitant or cutting and engaging in share buybacks which will ultimately increase the investors share of the pie without having to purchase any additional shares.

Finally, the company continues to increase the fixed portion of the dividend on a consistent basis as the share count declines and the company continues to build a cash pile, and an ever shrinking list of shareholders receive up to 50% of the free cash flow in the form of a variable dividend.

We expect oil prices to stay strong as discussed in the first section of this analysis.

Our favorite holding time is forever. We think this is a good statement of cash flows to purchase for the reasons provided. We are happy to collect these cash flows. This is not a guarantee of returns.

Please direct any questions to billy.lobue@leftskewed.com