FRANKLIN TEMPLETON

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Canadian Energy Roundtable

Webinar: Franklin Bissett Investment Management

In this webinar, **Franklin Bissett equity portfolio managers Izabel Flis, Mike Richmond and Les Stelmach**, along with **fixed income research analyst Naveed Sunderji**, discussed the state of the energy industry in Canada today, the longer-term outlook and implications for investors. These are the key takeaways.

An industry in transition

Globally, energy consumption is outpacing the growth of renewables. Sunderji pointed out that if traditional energy supply does not grow at the same time as renewables, supply will not keep up with demand. Renewables have lower capacity factors (percentage of time needed to run at maximum capacity) than hydrocarbons. Over longer time periods, they generate comparatively less energy and are vulnerable to demand shocks. Renewables are also less stable, added Flis, and can't yet substitute as base load supply. She noted the rolling blackouts in California last summer as the state's heavy use of renewable energy proved unable to keep up with the demand created by a severe heatwave. In her view, renewable energy should be considered as complementary in a diversified basket of energy sources.

Energy and ESG can coexist

For oil and gas companies, the emphasis on "E" (environmental) is really a "C" (climate change), said Stelmach. The scrutiny around gas emissions does not isolate one measure to the exclusion of others. Water and waste management, turnover rate, injury rates—these and many other factors are part of a comprehensive ESG analysis. On the governance side, regardless of sector, companies should follow best practices and have diversity of representation on their boards. From an emissions perspective, Canada produces a fairly high-standard barrel. For example, **ARC Resources Limited**, a longtime holding **in Franklin Bissett Dividend Income Fund**, is rated triple-A on ESG for a combination of emissions management, water management and governance. ARC was a royalty oil and gas trust for 25 years and has been a producer for the past five years. In that time, they have reduced emissions by 35% while increasing production by 36%, and not just by selling off high-emission assets. Focusing on its operations in northern British Columbia, the company negotiated with BC Hydro to electrify the area, resulting in zero emissions as opposed to using emission-producing generators. ARC also innovates; because fracking traditionally uses a lot of water, they are using MSDI drone-mapping technology to create a closed system to collect and reuse the water.

Pipeline and storage challenges to consider

Pipelines are controversial, said Flis, not just new ones but also those in operation. But pipelines are essential conduits for hydrocarbons—currently the safest, most efficient, most cost-effective and cleanest mode of transport from an environmental perspective. Demand and utilization are both robust, and not all infrastructure is valued equally; however, because no additional pipelines have been built and there is no feasible alternative, all existing pipelines are valuable. Longevity and cash flows for these assets are considered stable over the near future. They serve a diversified customer base, and some natural gas exports are already serving decarbonization efforts in developing nations. In the future, some pipelines may be converted to carry low-carbon recycled natural gas (RNG), hydrogen or carbon dioxide to be sequestered as these alternatives become more widely adopted.

Inflation, energy prices and corporate bonds

Monetary and fiscal stimulus during the COVID-19 pandemic led to a displacement in spending, noted Sunderji. At the same time, manufacturers, shippers and ports were focused on efficiency ("just in time") at the expense of resilience ("just in case"), leaving little flexibility to deal with demand shocks. Labour shortages and the potential for additional COVID-19 outbreaks further restricted labour supply. All of these factors have compounded with higher energy outputs, resulting in inflation and demand destruction. For example, higher gas prices for transporting potash have led to fertilizer plant shutdowns, causing shortages which in turn have led to higher food prices. On the bright side, if higher inflation continues in 2022, interest rates on corporate bonds will also rise. Less interest-rate-sensitive bonds should outperform, as they will have more carry to offset the impact of rising rates. Leveraged loans will be less exposed because of their floating rate structure and high yield should also do well. As companies become more concerned about the impact of higher costs on their profit margins, that will affect spreads. Franklin Bissett sees energy bonds outperforming because of higher commodity prices in an inflationary environment.

Energy companies in better shape these days

In terms of capital allocation, said Stelmach, the portfolio managers are generally happy with what they see. After seven years of mostly hard times, free cash flows are significantly higher. The excess is generally going to dividends, with some capital being raised. They are also seeing some share buybacks, but debt repayment is the more consistent theme and companies are not relying on banks as much for financing. Although there is more money to spend, there are also constraints from labour shortages and limited capital expenditures. All producers are price takers, Stelmach noted. Energy prices are influenced by inflation, and rising costs are keeping companies in line. Investors worried about inflation might want to look at royalty producers; investors get a percentage of production and can benefit in a rising inflation environment. Franklin Bissett Dividend Income Fund holds **Topaz Energy Corp.** and **Freehold Royalties Ltd.**, while **Franklin Bissett Canadian Equity Fund** holds **PrairieSky Royalty Ltd.,** another excellent company.

Great opportunities in good quality small caps

Small caps have been strong in 2021, noted Richmond. The S&P/TSX Small Cap Index is up 30% year to date and the energy sector, which comprises less than one-quarter of the index, has driven more than half of those returns. **Franklin Bissett Small Cap Fund** entered the third quarter slightly above market weight in energy exposure, and by quarter-end it had surpassed industrials, given the industry's strong returns. When determining commodity valuations in the fund, the portfolio managers model on the 12-month forward strip. Valuations have contracted but they are still seeing some great opportunities in good quality companies. The fund's top three positions are energy holdings; **Trican Well Service Ltd., Headwater Exploration Inc.** and **Storm Resources Ltd.** comprise 10% of assets. **Storm** is a small-cap gas producer active in the Montney region of northeast British Columbia. The company is being acquired by Canadian Natural Resources Limited, with the deal expected to close next month. **Headwater** is another high-conviction name. Richmond noted their wells are not expensive to bring online, they have a good balance sheet and are underappreciated by market.

Franklin Bissett Dividend Income Fund

This fund seeks long-term capital appreciation by investing primarily in dividend-paying or income-producing Canadian securities, including common shares, income trust units and preferred shares. Portfolio managers look for quality companies at reasonable prices that have a proven ability to deliver a consistent and growing level of dividends over time.

Franklin Bissett Small Cap Fund

This fund seeks long-term capital appreciation by investing primarily in a diversified portfolio of small-capitalization Canadian equities that have proven management and lont-term growth plasn. The fund may also invest in foreign securities.

Franklin Bissett Core Plus Bond Fund

This flagship five-star Morningstar-rated* fund seeks a high current income and some long-term capital appreciation by investing primarily in Canadian federal and provincial government and corporate bonds, debentures and short-term notes. The fund maintains an overweighted position in high-quality corporate and provincial issues, an underweighted position in Canadian federal bonds and may invest in foreign securities. This strategy is also available as an ETF, Franklin Liberty Core Plus Bond ETF (FLCP).

Franklin Bissett Corporate Bond Fund

This award-winning** fund seeks a high current income and some long-term capital appreciation by investing primarily in bonds, debentures, notes, revenue bonds, as well as asset- and mortgage-backed securities of Canadian corporate entities.

Franklin Bissett Investment Management

Franklin Bissett offers Canadian investors a legacy of expertise in Canada's capital markets. Founded in 1982, the company has managed institutional, high net worth and retail assets as part of Franklin Templeton since 2000.

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Performance for the fund for the period ended October 31, 2021, is as follows: 3.1% (1 year), 5.7% (3 years), 3.7% (5 years), 4.0% (10 years) and 4.2% (since inception on December 18, 2006). The corresponding Lipper Leader ratings of the fund for the same periods are as follows: 5 (Overall), 5 (3 years), 5 (5 years), 4 (10 years). Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional