Don’t Write Off Encana Just Yet

Description

It’s ugly at **Encana** (TSX: ECA, NYSE: ECA). With natural gas prices in the dumps, shares of the Calgary-based company are nearing multiyear lows. But there’s a turnaround brewing at the troubled firm and investors should keep this stock on their watchlist.

Is a turnaround in the works?
Encana as we know it today was formed on Dec. 1, 2009, when the prior version of the company was split into the integrated oil producer **Cenovus** (TSX: CVE, NYSE: CVE) and a natural gas pure-play producer called Encana. But investors of the new Encana haven’t had much to celebrate since the transaction. The company’s share value has fallen more than 50% after the drop in natural gas prices decimated cash flows.

To turn around the struggling company, Encana turned to former **BP** executive Doug Suttles to right the firm’s troubled financial ship. During the company’s previous quarterly conference call, Suttles laid out his four-part action plan:

1. Wring efficiencies out of existing operations
2. Improve capital discipline
3. Increase oil and liquids production
4. Develop a comprehensive business strategy by year-end

The success of Encana’s turnaround hinges on its ability to increase oil and liquids production as these commodities command higher prices and therefore generate better cash flow. But herein lies the problem for the company: Encana needs more oil and liquids production to improve cash flow, but first needs enough cash to develop these oil and liquid assets. To generate these funds, the company has been selling prized assets and conceding control of projects through joint ventures.

In spite of these problems, management already seems to be making progress on its turnaround efforts. Last quarter, the company cut $152 million in governance and administration costs while offloading marginal assets. Investors should be watching Encana’s production mix closely in upcoming quarters.

Suttles is also not ruling out a sale or merger. The company has engaged the services of a bank and a consulting firm to help craft a new strategy. The most likely bidder for Encana would be a large U.S. company such as **ExxonMobil** or **Chevron**. **PetroChina**, **China Petrochemical**, and **Sinopec** would also be interested bidders. However, an acquisition led by a Chinese company would be difficult to get past regulators.

Tongue in cheek comment here, but don’t rule out a merger between Encana and Cenovus. While it may seem crazy, such a deal could make a lot of sense due to the complementary assets, consolidated office space, and familiarity with the players and portfolios. The overlap of personnel would also allow for some significant cost reductions.

The stock is cheap
In addition to a possible turnaround, the stock is incredibly cheap. As of the close on Aug. 30, Encana’s Enterprise Value-to-Proved Reserves was $1.31/mcfe. That’s roughly the capital cost of developing promising acreage, according to the company’s financial reports. At this valuation, the market is assuming that producing current proved reserves will do no better than pay back sunk capital.

More interesting, the market is valuing the company’s contingent reserves — gas that can’t be economically exploited at current prices — at basically zero. These gas resources are several times proved reserves and they’re likely to generate significant profit in the future if gas prices rise. Yet Mr. Market will throw them in for free.

Let’s have a quick check of Encana’s valuation compared with some peers:

Company	EV/EBITDA	Price/Book	Price/Cash Flow
Encana	5.36	2.38	4.58
Chesapeake Energy	6.17	1.32	4.17
EOG Resources	5.92	2.97	7.14
Southwestern Energy	6.97	3.98	7.89
Talisman Energy	4.56	1.17	5.19

Source: Morningstar.com and company financials.

As you can see, Encana is also trading at a cheaper multiple relative to its peers. With a new CEO at the helm and a potential turnaround as catalysts, the stock could quickly close that valuation gap.

Foolish bottom line
At this valuation, the market is saying gas won’t be profitably produced again for decades. That may be true. But remember, back in 2003 a long-term natural gas shortage in North America appeared inevitable. Today, a fracking-induced supply glut is expected to last for as far as the eye can see. The paradigm can change drastically. Don’t write off natural gas — and by extension Encana — just yet.

More stock ideas for you

Canada's resources have been powering the developing world in general and China in particular. But the big money in our country's energy stocks may not be in natural gas — it may be in uranium, the key ingredient for nuclear power. The Motley Fool's chief analyst has prepared a free research report detailing his two favorite uranium companies in Canada. You can download your copy by clicking here — it's totally free!

Disclosure: Robert Baillieul has no positions in any of the stocks mentioned in this post.

The Motley Fool has the following options: long January 2014 $30 calls on Chesapeake Energy.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CVE (Cenovus Energy Inc.)
2. TSX:CVE (Cenovus Energy Inc.)

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rbaillieul