Canadian Natural Resources: A Solid Undervalued Play in Canada's Oil Patch

Description

I've spent the past month investigating the challenges facing Canada's oil sands industry in an attempt to determine whether the industry is sustainable. In the final article of that series, I concluded that despite the industry's many challenges, it is too early to call it unsustainable. I also found that many of the major companies operating in the industry now sport attractive valuations.

One company that stands out is **Canadian Natural Resources** (TSX:CNQ)(NYSE:CNQ), which is set to report record production for the third quarter of 2013.

Record results
Canadian Natural Resources is set to formally report its third-quarter 2013 results on Nov. 7, but it's already clear that the company has had a strong operational quarter. Oil production for the quarter has already been reported: up 12% quarter over quarter to 701,000 barrels.

As such, I'm expecting significantly higher revenue and cash flow. Not only because of the record production, but because the price of crude surged to a one-year high in August 2013. Canadian Natural Resources recently announced that it estimated third-quarter 2013 cash flow to be up 38% quarter over quarter to $2.4 billion. All of which is to say: Investors should see a nice bounce in earnings per share, which should eventually translate into a higher share price.

Appears undervalued
When considering a number of key ratios used to value oil companies, Canadian Natural Resources already appears undervalued. So any growth in cash flow and earnings does not appear to be baked in.

At the time of writing, the stock is trading at an enterprise value of 7 times EBITDA and 9 times its proven oil reserves; it's also trading at 6x its cash flow per share.

These are particularly attractive valuation ratios and are significantly lower than the industry average for similarly sized independent oil explorers and producers. Let's take a closer look to see how this compare to its competitors.

Company	**EV-to-EBITDA**	**EV-to-Reserves**	**Price-to-Cash-Flow**

Suncor	5	14	6
Husky Energy	6	26	6
Canadian Nat Res	7	9	6
Cenovus	7	13	7
Talisman	8	6	9
Imperial Oil	9	12	11

Source: Company Financial Filings and Yahoo! Finance.

Clearly Canadian Natural Resources on the basis of all three ratios appears undervalued in comparison to its competitors. Only **Suncor** appears to be almost as attractively valued, while **Imperial Oil** looks to be the most expensive on a comparative basis.

However, if we look at each company's return on capital employed (or ROCE), as explained in a recent article by fellow Fool Robert Baillieul, Imperial Oil is the star.

Company	**ROCE 5-Year Average**
Imperial Oil	25%
Husky Energy	12%
Cenovus	11%
Canadian Nat Res	10%
Suncor	8%
Talisman	5%

Source: Company Filings and Fool.ca.

In order to grow, Canadian Natural Resources has engaged in a number of low-margin, high-development-cost projects, which historically has been a symptom of oil sands development and production. But with it now focused on growing its higher-margin crude production and controlling costs — which will boost margins — its ROCE should improve.

Foolish bottom line
I am expecting Canadian Natural Resources to report strong operational results for the third quarter.

If I'm right about that, and if paired with solid oil reserves, growing production, and stronger cash flow, the company appears to be a good value at current prices.

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Fool contributor Matt Smith does not own shares of any companies mentioned.

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1. NYSE:CNQ (Canadian Natural Resources)
2. TSX:CNQ (Canadian Natural Resources Limited)

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Date
2025/09/11
Date Created
2013/11/05
Author
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