How Encana Is Getting Back to Winning

Description

Christmas has come early for **Encana** (TSX: ECA, NYSE: ECA) shareholders this year. Yesterday, the company unveiled its much anticipated turnaround strategy. But did Chief Executive Doug Suttles deliver everything that was on investors' wishlist this year? Let's review:

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Sell off non-core assets…Check.

Shift production mix to more profitable liquids and oil…Check.

Cut costs and deleverage the balance sheet…Check.

Suttles hit on almost every point he promised after taking over at the company this summer. He even left an unexpected surprise in investors' stockings.

What will the new Encana look like?
In an effort to turnaround the struggling natural gas company, Mr. Suttles has vowed to cut Encana's dividend, chop its work force, and sell off non-core assets.

Encana plans to focus most of its investment dollars on five liquids-rich plays: the Montney, Duvernay, DJ Basin in Colorado, San Juan oil play in New Mexico, and the Tuscaloosa marine shale in Mississippi and Louisiana. Assuming commodity prices remain in line with where they are today, the company is aiming to generate 75% of its cash flow from liquids production by the end of 2017.

But the key theme coming out of Mr. Suttles' presentation was 'cuts'. Encana plans to layoff 20% of its employees in a bid to trim costs. Offices will be consolidated in Denver and Calgary. The Plano, Texas headquarter will be closed. Encana also slashed its dividend 65% to $0.07 per share per quarter. An aggressive move that will save the company almost $380 million per year. And while Mr. Suttles didn't provide specifics, most of the firm's dry gas assets are now on the chopping block.

And in a surprising development, Encana will announced that it would spin off a new company holding about five million acres of mineral fee title land in Southern Alberta. The new company will lease the land out to junior exploration companies in exchange for a steady stream of royalty cheques.

In essence, Encana will become a landlord receiving income from these properties but without having to front the cash for development work. The downside is that Encana's financial reward from the production of these land holdings will be less than had they developed them on their own. However, it's an unrecognized asset on the company's books that will finally be put to good use.

So the new Encana is going to look a lot smaller and oiler than its predecessor. In fact, the company is going to look a lot like it did before the split from **Cenovus** in December, 2009.

So what should shareholders think?
Shareholders should be pleased with yesterday's announcement. The transition away from dry gas to a more liquid production mix will be a big boost to the bottom line. Cutting costs and paring down debt was a needed response to lower commodity prices anyway.

Management is no longer hoping for a rebound in natural gas prices, of which they have no control over. Rather, they're adjusting operations in response to the new market reality.

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Yes, some shareholders will be disappointed with the dividend cut. But this shouldn't be unexpected, given that the company was paying out 95% of profits. The move will protect Encana's investment grade credit rating and finance its restructuring.

But it won't be all sugar plums and fairies for Encana. Investors should be worried about how much the firm will actually realize in these planned asset sales.

Talisman's (TSX: TLM, NYSE: TLM) turnaround has been slow. Like Encana, Talisman has been trying to shop its less profitable dry gas assets to refocus on liquids and oil production. However, there's been no interest in the company's Montney or North Sea properties. Unless shareholder activist Carl Icahn can bring in a buyer, his pressure to speed up the process won't help.

With both companies trying to unload similar assets at the same time, it has created a buyer's market.

Foolish bottom line
Problems aside, Mr. Suttles has laid out a solid vision for Encana. Now we have to watch quarter by quarter to see if he can actually execute on that plan. The shrink-to-grow strategy won't stoke any egos in Calgary boardrooms. However, it's the most profitable path forward and is in the best interest of shareholders.

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