Can Cenovus Capitalize on These Opportunities?

Description

By: Robert Zimmerman

Fellow Fool Matt DiLallo and I have been examining **Cenovus Energy** (TSX:CVE) through a SWOT analysis. To be sure, Cenovus has its strengths and weaknesses. In this article, I will examine some opportunities for Cenovus while Matt will separately look at some looming threats in a subsequent post.

A big oil reserve and an efficient means of getting it out
Without a doubt, Cenovus sits on a pile of oil. While overall reserves are 93 billion barrels, only 3.1 billion barrels are proved or probable. Still, that's not a bad resource to base your business on. Much of Cenovus' oil comes in the form of oil sands.

And perhaps the most intriguing thing about this resource base is the way that Cenovus extracts it. You see, Cenovus pioneered so-called Steam Assisted Gravity Drainage (SAGD) technology. Rather than dig oil sands out of the ground with all of the environmental impact that this involves, Cenovus injects steam into the ground and then collects heated oil from a well drilled below the steam injection site. This process is much cleaner than just digging the stuff up.

For investors, SAGD technology demands extracting oil with as little steam as possible, and Cenovus is an industry leader at doing just that. Currently, Cenovus can produce oil for as low as $35 a barrel – a significant price advantage over the industry average of $70 a barrel. This advantage is partly due to the relatively low steam-to-oil ratio Cenovus enjoys. Even better, Cenovus has decreased its production costs from all its major oil plays by about $5 a barrel over the past three years.

Excess refining capacity for bitumen
One detail that may have gone unnoticed in booming US oil production is that most of the oil produced is light sweet crude. Good stuff, but many US refineries simply are not equipped to handle this volume of light crude. That is, there is a relative surplus of light sweet crude while heavier crude is in demand. This imbalance has been driving the Keystone XL pipeline.

Cenovus can help itself in this regard. Through joint ventures with **Phillips 66** and **Conoco**, Cenovus owns interests in two US refineries that use heavy oil. However, the combined heavy crude refining

capacity runs about 250,000 barrels a day and Cenovus hopes to produce more than that. Where else will this oil go? A company like **Valero Energy** will likely take it.

Valero operates refineries that traditionally use heavier crude oil to exploit its cost advantage over light sweet crude. For example, Valero's St. Charles refinery on the U.S. Gulf Coast can handle 190,000 barrels of crude oil a day, much of that heavy sour oil.

In its recent investor presentation, Valero anticipates its St. Charles refinery receiving roughly 55,000 barrels of heavy Canadian crude a day from rail and barge on top of whatever comes in by pipeline. It bears mentioning that Valero has committed resources to modify more of its refineries to handle light sweet crude coming from U.S. sources. So this opportunity for Cenovus may have limited growth potential.

Rail to the rescue
While it's good to know there are refineries able to take the heavy crude Cenovus produces, getting the oil to the refinery can be problematic. There are oil pipeline expansions under way, but these won't come online until 2017. As Valero learned, railroads can pinch hit nicely. Not only do railroads ship oil to North American refineries, they can also deliver oil to ports for export. In the case of Cenovus, rail shipments hopefully will grow from 6,000 barrels a day to more than 30,000 barrels a day.

Canadian National Railway (TSX:CNR) provides an excellent example of railroads benefiting from Canadian oil production. Since 2010, the number of carloads of crude oil has grown from 216 to more than 34,000 in 2012. The latest quarterly report showed continued increases in the petroleum and chemicals division.

The company has been sharing the wealth with not only increased earnings per share, but a steady increase in dividends paid. In 2010, Canadian National paid C$1.01 a share. In 2013, it estimates a dividend payment of C$1.72 a share. Total number of shares outstanding also declined, further enhancing shareholder value.

Final Foolish thoughts
Cenovus sits on a pile of oil that U.S. refiners can use. The company produces this oil using low-cost SAGD technology that is cleaner than digging oil sands out of the ground. While pipeline bottlenecks impede both delivery and price of its oil, railroads provide a viable alternative. These opportunities, the low cost oil, the U.S. refinery market, and the railroad alternative to pipelines all should fuel continued growth for Cenovus and its investors.

CATEGORY

1. Investing

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1. TSX:CNR (Canadian National Railway Company)
2. TSX:CVE (Cenovus Energy Inc.)

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