Natural Gas Continues to Spike Higher — How Can You Profit?

Description

Natural gas closed at $5.275/bcf yesterday, and volatility has definitely been on the rise. There are two schools of thought on the future of natural gas prices. The first is the belief that this spike in natural gas prices is a temporary reaction to the frigid weather that has gripped North America this winter.

Now let's look at the second, less popular, school of thought. Unconventional, or shale, natural gas production has driven the market to a position of oversupply in recent years. U.S. shale gas production increased sixfold to 265 billion cubic meters last year from 75 billion in 2007.

Five years after hitting a low of roughly $2.00 per mcf in 2008, natural gas prices have been hitting four-year highs recently. And some experts say that there are signs that this production boom will slow down and natural gas prices will settle higher than previously thought. There are four premises that this case is built on. Three relate to the supply side of the natural gas market, and one relates to the demand side. Let's walk through each premise.

1. The decline rate (rate at which a well's production declines) on unconventional wells is very steep.

2. Shale reserves estimates are being reduced. Last year, we saw more than one negative revision of U.S. shale reserves. This is concerning and implies that initial estimates of shale gas recoverability may have been too high. **Royal Dutch Shell** (NYSE:RDS) recently announced a write-down of just over $2 billion related to its North American shale assets. **BHP Billiton** (NYSE:BHP) has also had to write down its U.S. shale assets. This is due to low natural gas prices but also because exploration and drilling results are coming in weaker than anticipated.

3. Conventional natural gas production has been declining for years.

4. Liquified natural gas (LNG) is a new source of potential big demand.

Natural gas stocks to watch

Birchcliffe Energy (TSX:BIR), **Peyto** (TSX:PEY), and **Tourmaline** (TSX:TOU) are three natural gas-focused companies that will benefit from this spike in natural gas prices.

Birchcliffe's production is 76% weighted to natural gas, and its stock price has increased over 13% year-to-date. The company has seen good production growth last year. Production increased 15% in the third quarter of 2013 and almost 17% in the first six months of 2013.

Peyto is another company that is heavily weighted toward natural gas production, at almost 90%. In the third quarter of 2013, production per share increased a healthy 18%, and cash costs remained industry leading at $1.07/mcfe. Its stock price is pretty much flat year to date.

Lastly, Tourmaline is also heavily weighted toward natural gas production. Last year 89% of its production was natural gas and the company is achieving very strong production growth rates (46% growth in production in the first nine months of 2013. And as icing on the cake, the company has a healthy balance sheet. Tourmaline's stock price is up almost 4% year-to-date.

Foolish bottom line

While these natural gas producers have hedged some of their production going forward, these companies obviously still have exposure to rising prices. With the upcoming release of fourth-quarter 2013 results and first-quarter 2014 results, we will very likely see these companies beating estimates and surprising to the upside. And it is up to investors to decide whether this is a short-term phenomenon or the beginning of a longer term trend.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:BHP (BHP Group)
2. TSX:BIR (Birchcliff Energy Ltd.)
3. TSX:PEY (Peyto Exploration & Development Corp)
4. TSX:TOU (Tourmaline Oil Corp.)

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