The Stock Picker's Guide to Cenovus Energy for 2014

Description

"I believe we've set a new standard for what SAGD projects are capable of achieving – and that's exciting." Those words came from John Brannan, EVP and COO of **Cenovus Energy** (TSX:CVE)(NYSE:CVE).

Cenovus is a large-scale energy producer in western Canada, with production of 180 million barrels per day of oil and natural gas liquids. The company also has 230,000 barrels per day of refining capacity. Cenovus became an independent entity back in late 2009 when natural gas behemoth **Encana Corp.** (TSX:ECA)(NYSE:ECA) spun off its oil assets.

The bulk of Cenovus's oil production comes from steam-assisted gravity drainage, better-known as SAGD. The process involves drilling two horizontal wells, and injecting steam into one of them. The other well is used to suck up the bitumen. The key to any SAGD project is the steam-oil ratio (SOR), which measures how many barrels of steam are required to produce one barrel of bitumen.

A lower SOR ratio means not only lower operating costs, but also lower capital costs as well as a lower environmental footprint. Cenovus's projects have an SOR ratio of as low as 2.0, which is less than half of some of their peers – by comparison, **Suncor's** (TSX:SU)(NYSE:SU) Firebag operation has an SOR above 3.0. As a result, the company's two producing SAGD projects, Foster Creek and Christina Lake, are two of the most efficient SAGD operations in the industry. Some of Cenovus's production only needs a $35 oil price in order to generate a 10% return on investment, and all of the company's production is below the global average supply cost of $70.

Needless to say, with oil selling for about $100, Cenovus is able to earn excellent return on its production. For this reason, it is good news for the company's investors that Cenovus is aggressively expanding production. Cenovus hopes to more than double bitumen production by 2017 and quadruple production by 2023. The dividend has taken a bit of a back seat, and understandably so. In 2013, the company paid out a total of $0.96 per share in dividends – not much for a $30 stock. By comparison, the company has spent well over $4 per share in capital expenditures.

With such excellent economics, it is not surprising that Cenovus's shares are not especially cheap. The company's enterprise value, which equals its market capitalization plus net debt, is $36 per share. Meanwhile the net present value of the company's reserves (after tax with a discount rate of 10%) is $32 per share, based on 2012 reserves numbers. And over half of those reserves have yet to be developed.

Yet the shares still trade at the same level that they did back in April 2010, despite all the progress that Cenovus has made since that time. Clearly there have been concerns about price differentials for Canadian heavy oil, and many investors would prefer to wait on the sidelines until Keystone XL's fate is decided. Others have opted to go with companies that pay a higher dividend. But with such a strong track record, and fantastic economics, Cenovus's premium may well be worth paying.

CATEGORY

1. Investing

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