7 Reasons Why EnCana Should Continue to Outperform

Description

With the release of its first quarter 2014 results, **EnCana** (TSX: ECA)(NYSE: ECA) continues to gain investors' confidence. Now is a good time to review the company and the stock, and see where we stand in order to determine where we are headed.

EnCana stock has a six-month return of over 32% versus a 15% return for the **TSX/S&P Energy Index** (^SPTTEN). For further comparison with some of the other large cap energy stocks, the six-month return for **Suncor** (TSX: SU)(NYSE: SU) and **Imperial Oil** (TSX: IMO)(NYSE: IMO) are 15% and 17% respectively. Here's why we should expect Encana's outperformance to continue.

Exposure to natural gas

Although EnCana is working hard at reducing its exposure to natural gas, it is still heavily exposed to the commodity, with 87% of its production from natural gas in the first quarter. I view this as a good thing, given the outlook for the next year. Storage levels will likely be more difficult to replenish than the market expects. According to the U.S. Energy Information Administration (EIA), current inventory levels stand at 1,055 bcf. This is almost 50% lower than the five-year average, which is a bullish sign for natural gas prices.

As a reminder, the company expects that by 2017, 75% of the company's cash flow will be from higher-value natural gas liquids.

Strong cash flow growth continues

As EnCana continues to benefit from stronger natural gas prices, the first quarter saw a very strong 88% increase in cash flow, from U.S. $579 million in the first quarter of 2013 to U.S. $1.094 billion in the first quarter of 2014. Cash flow for the oil and liquids segment increased 69%, driven by production increases, while cash flow for the natural gas segment almost doubled, driven by pricing increases.

Although natural gas production decreased by 2.4%, EnCana’s realized natural gas price increased by over 50%. Oil and natural gas liquids had the opposite experience, where production increased 56%, but realized pricing decreased marginally.

For 2014, the company updated its guidance for cash flow. Management now expects cash flow of between $2.9 billion to $3 billion, up from prior guidance of between $2.4 billion to $2.5 billion. This is due largely to stronger than expected natural gas prices.

Strong performance from core assets

In the DJ Basin, EnCana continues to exceed expectations. With drilling costs down between 5-15%, depending on the well, this play is seeing efficiency and profitability improvements. At the Montney, initial production rates have increased by approximately 75%, with drilling costs roughly 15% lower. At the San Juan basin, costs are declining and well cycle times are also declining.

Lowering decline rates on base assets

Due to different initiatives such as well recompletions and field booster compressors, EnCana expects to achieve a 10% reduction in its 2014 base decline to 25-27%.

Strong balance sheet

EnCana continues to make improvements to its balance sheet. As of March 31, EnCana had $2.2 billion in cash and cash equivalents on its balance sheet. Furthermore, with the sale of the Jonah Field, $1 billion of debt was paid off, and there are no further debt maturities until 2017. The current net debt to cash flow ratio stands at a very healthy 1.2 times.

Attractive valuation

Using the mid-range of the company’s 2014 cash flow per share guidance, i.e. $3.98, EnCana is trading at a P/CF of 6.3 times. This compares to Suncor, which is trading at a P/CF on trailing cash flow per share of 6.7 times and Imperial Oil, which is trading at a P/CF on trailing cash flow per share of 10.8 times.

Cash flow from PrairieSky Royalties

EnCana will receive royalties from the PrairieSky spinoff, which will control 5.2 million acres of land in Alberta, where production is free from government royalties. EnCana is expected to be the majority shareholder in the spin off, which will pay out the majority of its cash flow in dividends.

At EnCana, the focus remains on maximizing value, not production. And the proof that this strategy is a sound one is in the results.

CATEGORY

1. Investing

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2. NYSEMKT:IMO (Imperial Oil Limited)
3. TSX:IMO (Imperial Oil Limited)
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