What the Poor Outlook for Natural Gas Means for Investors

Description

The operating environment for natural gas producers has been challenging for some time, and all of the signs indicate it will remain that way. Low natural gas prices, a less than optimistic long-term outlook for natural gas demand, and rising costs are pushing down margins and threatening investment in an industry that until recently appeared highly profitable.

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What is the outlook for natural gas?

Over the last five years, natural gas prices have oscillated wildly and despite recovering somewhat recently are still weak, generating relatively thin margins for natural gas producers.

Over the last year, natural gas prices have spiked a massive 30%, primarily due to record consumption driven by colder than expected weather last winter. This was a boon for natural gas producers, but with the long-term outlook less than optimistic, now is the time to avoid these companies.

When looking at natural gas futures, it is expected that natural gas prices will soften by 12% over the next two years, or for contracts due at the end of June 2016. The International Energy Agency expects natural gas demand to remain relatively soft over the longer term and not increase at the rate previously expected because of slower economic growth and increased competition from coal and renewable energy sources. Rising costs are also having a significant impact on the industry and seeing a number of companies delaying developments or putting them on hold indefinitely.

What does this mean for investors?

Investors should avoid oil and gas companies that have a large proportion of their production made up of natural gas, compared to higher margin crude and natural gas liquids. Lower prices, higher development and operational costs, and lower margins are set to hit their bottom lines hard.

These issues are an important reason why Canada's largest producer of natural gas, **EnCana** (TSX: ECA)(NYSE: ECA), is focused on boosting natural gas liquids production and divesting itself of dry natural gas assets as part of its turnaround strategy. This has seen EnCana reduce its Q1 2014 natural gas production as a portion of its total production mix by 5% compared to Q1 2013.

As a result, the profitability of EnCana's operations improved significantly, with its operating netback more than doubling year over year. This significant boost to the profitability of EnCana's production saw operating cash flow, a key measure of the financial health of oil and gas producers, more than double for the same period.

The company is also focused on further developing its operations and assets in the liquids-rich Montney. This is not only because of the high proportion of natural gas liquids and condensates in the formation, but also because it is believed by the National Energy Board to have some of the lowest development costs. More importantly, demand for condensates is growing fast as they are an important diluent used to make heavy crude and bitumen flow for transportation via pipeline.

This highlights the importance of EnCana's dominant position in the Montney and the moves being taken to boost its crude liquids production, which bodes well for higher margins, improved profitability, and a stronger bottom line.

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Investors should be guarded when investing in companies that are struggling through restructures aimed at rebuilding shattered balance sheets, divesting non-core assets, and boosting liquids production.

This includes intermediate oil producers such as **Pengrowth Energy** (TSX: PGF)(NYSE: PGH) and **Penn West Petroleum** (TSX: PWT)(NYSE: PWE). Both are attempting to boost crude liquids production while rebuilding their overleveraged balance sheets and retaining capital.

Both companies continue to see their margins and the profitability generated by their operations suffer because a significant proportion of their production mix is allocated to natural gas.

For the first quarter of 2014, natural gas made up 45% of Pengrowth's production mix and 35% of Penn West's. This is significantly higher than many other light oil producers, including **Lightstream Resources** (TSX: LTS) and **Crescent Point Energy** (TSX: CPG)(NYSE: CPG), which for the same period had natural gas weightings of 19% and 9% respectively.

This high production weighting to natural gas is hurting Pengrowth and Penn West's margins, the profitability of their operations, and their bottom lines. This is evident when their relatively low operating netbacks per barrel, a key measure of operational profitability, are considered.

For the first quarter of 2014, Pengrowth reported a paltry netback of $29.71 per barrel, which is significantly lower than EnCana's $31.64, even with Pengrowth's production being more heavily weighted towards crude liquids. For the same period, Penn West's netback was $36.67 per barrel.

Both Pengrowth's and Penn West's netbacks are significantly lower than Lightstream's $56.11 and Crescent Point's $52.65 per barrel, which highlights the low profitability of their operations.

For those companies with high production weightings to natural gas, growing development and operational costs and softer natural gas prices will continue to hurt their margins and profitability. This is particularly the case for those companies that are vulnerable because of restructuring.

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