Does Encana Corporation's Takeover of Athlon Energy Inc. Make it a Buy?

Description

It's been a rough couple of years for natural gas.

With the exception of a spike in the commodity's price earlier this year, natural gas has spent the last few years floundering, usually under $4/MMBTU. This is partially because the weather has been warm, but mostly because supplies are still near record highs. Essentially, North America is awash in cheap natural gas.

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This is good news for consumers, but bad news for gas producers. Canada's largest producer, **Encana Corporation** (TSX: ECA)(NYSE: ECA), has been hit particularly hard. Shares have fallen from a high of more than $35 in 2010 to just $23 today, and the company even cut its quarterly dividend, from 20 cents per share to just 7 cents per share, back in late 2013.

To management's credit, Encana has done a nice job during the downturn. It cut costs significantly, and sold off non-core assets. It has started to make quarterly profits again, after years of red ink. And it recently paid $3.1 billion to acquire mostly oil properties in the Eagle Ford basin in Texas, which look to have a net cost between $35 and $45 per barrel, making them solidly profitable.

On Friday, the Encana announced it had completed a secondary offering for **PrairieSky Royalty Ltd.** (TSX: PSK), which netted the company $2.6 billion before taxes. That, combined with the $2.6 billion of cash the company already had on the balance sheet, led analysts and investors alike to speculate a major acquisition was on the horizon.

The company didn't waste any time, announcing just this morning that it agreed to pay $5.9 billion (plus the assumption of $1.1 billion of debt) for **Athlon Energy Inc.** Athlon is a leading producer in the oil-rich Midland basin in Texas, thought to be one of the finest oil fields in North America.

And it moves Encana from a pure natural gas company to a close to 50/50 production split between oil and natural gas.

There's a lot to like about this acquisition. It opens up a seventh growth area for the company, approximately 140,000 acres in a terrific location. Athlon also has approximately 10-11 years of reserves, and further exploration could yield impressive amounts of other liquids.

But while the market is applauding the company's move back into oil, I can't help but to think back to 2010 when the company split off its oil assets (forming **Cenvous Energy**) from the main company, choosing to concentrate on natural gas. I remember some of the reasons given, like the market was discounting the oil assets because of the weakness in natural gas prices, and that the two companies would be better equipped to deal in their respective markets. So from that perspective, the company's move back into oil is a little puzzling.

It also has to be bearish for natural gas going forward. One of North America's leading gas producers was flush with cash, and used the money to buy oil assets. If anybody would know the natural gas market. it would be Encana's management. I don't think this bodes well for gas going forward.

Overall, I like the transaction. It makes sense to diversify away from natural gas, especially in this environment. There's a lot of supply on the market, and we're still years away from meaningful LNG exports to Asia or Europe. But I see Encana running into the same problems it dealt with a few years ago. The oil assets will continue to get undervalued because of the gas exposure.

At this point, an investment in Encana isn't a bet on oil or natural gas, but a bet on energy prices in general. If gas continues to be weak, this should lessen investor pain. But if it's strong, the stock will underperform its peers. As long as prices for both commodities continue to head higher in the long term, investors should be fine.

Personally, I'd stick with a pure oil or a pure gas player, depending on what your preference is. A pure play should have more upside.

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CATEGORY

1. Energy Stocks
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TICKERS GLOBAL

1. TSX:PSK (PrairieSky Royalty Ltd.)

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Date
2025/07/22
Date Created
2014/09/29
Author
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