Why Now Is the Time to Buy Canada's Heavy Oil Producers

Description

The past several years have not been kind to Canadian heavy oil producers. Western Canadian Select (WCS), which is the heavy oil blend most commonly produced from the oil sands, has traded at a huge discount to West Texas Intermediate (WTI), the common North American benchmark.

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In fact, even Canadian synthetic crude, an upgraded form of bitumen which is easier to refine, trades at a discount to WTI. This differential is largely due to the unique market access issues facing Canadian producers. Canadian heavy oil has limited pipeline access to gulf coast refineries, and so it ends up stuck in the American midwest, which has little heavy oil refining capacity.

Fortunately, the economics are shifting in heavy oil's favor. Here's what's changed, and why this is a fantastic opportunity to pick up shares in Canadian heavy oil producers like **Suncor Energy Inc** (TSX: SU)(NYSE: SU) and **Canadian Natural Resources Limited** (TSX: CNQ)(NYSE: CNQ).

Why is heavy oil now attractive?

WTI prices have dropped almost 8% since the beginning of October, and over 20% since the summer. What is less known is the prices for WCS have risen during that time, and as a result, the differential between WCS and WTI is at its lowest point in over a year.

In fact, analysts are expecting new record price averages for WCS this year. This is good news for Canadian producers and can be attributed both to the weaker Canadian dollar (which helps crude exporters), and the fact producers are having a much easier time moving crude to markets, a trend set to continue.

A few things have been behind the easier market access. First, U.S. refineries have been increasingly revamping their operations to process heavy crude (such **BP**'s Whitning refinery in Indiana). Since most of the heavy oil refining capacity has been located in the Gulf Coast region, which has limited pipeline access, Whitning will help relieve the supply glut of Canadian oil stuck in the midwest.

Second, there is growing access to the Gulf Coast refining hub. Approximately 1.6 million bpd of pipeline access between the midwestern U.S. and the Gulf Coast has been created in the past year and a half. This will continue, with **Enbridge/Enterprise** twinning its Seaway Pipeline, which moves 850,000 bpd to the Gulf Coast region, and **Enbridge's** Flanagan South pipeline from Illinois to the oil hub in Cushing, Oklahoma, which is nearing completion, and will add over 500,000 bpd of capacity.

On top of the increased pipeline access, rail has been a growing interim solution for producers, with usage growing substantially. These factors combined will lessen the discount between WCS and WTI, which will ultimately benefit Canadian heavy oil producers.

Suncor and Canadian Natural Resources are bargain heavy oil plays

Suncor and Canadian Natural both had their shares drop over 20% from highs this year. These are two of Canada's premier energy companies with Canadian Natural being Canada's largest producer of heavy oil, accounting for 35% of its production.

Suncor is Canada's largest oil producer, and has strong exposure to heavy oil. Both of these companies have excellent management teams, solid and growing free cash flow, long-life, long-decline assets, and good production growth. Their diversity and integration, along with large heavy oil production makes them safe plays on heavy oil, and poised to benefit from improving WCS pricing.

Most importantly, they are both trading at a huge bargain. Suncor is trading at its lowest forward price-to-earnings in one year, and Canadian Natural is trading at its lowest in two.

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amancini

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