Could Oil Prices Really Fall to $43 Per Barrel?

Description

If you're investing in the oil companies, the news keeps getting worse. On Monday, the international oil price fell another US$2 barrel, after Morgan Stanley analyst Adam Longson said prices could fall as low as $43 per barrel next year.

Could this really happen? And what should investors do? Below we take a closer look.

That number sounds familiar…

It's no secret that increased production from the United States has been a main contributor to oil's downfall. Now one obvious question remains: Can American drillers continue to make an acceptable return with such low prices? Or will they go bust, leading to reduced supply and an oil price rebound?

Well, recent data from North Dakota – a state responsible for much of this surge in production – says that drillers only need $42 oil to make a 10% return on investment. So could this be how Mr. Longson got his $43/barrel number? Quite possibly, yes. And no one can blame him for that.

Saudi Arabia: in it for the long haul

Over on the other side of the world, it costs Saudi Arabia less than $5 to produce a barrel of oil. So low prices will never force the company to cut production. And the country has made it very clear that it will not cut output just to see others gain market share. One cannot blame the Saudis for this mindset.

So this now seems to be a war of attrition, with the breaking point for many American producers being $42 per barrel. Until that price is reached, supply could easily keep growing. Suddenly that oil price seems a lot more realistic.

So what should you do?

One very compelling option is to avoid the energy sector altogether. You can't really go wrong with this strategy.

But if you want some exposure, just in case Mr. Longson is wrong, there are some very important things to look for. You want a company with a low cost of production, long-life assets, and a clean balance sheet.

With that in mind, two companies stand out in particular: **Suncor Energy Inc.** (TSX: SU)(NYSE: SU) and **Canadian Natural Resources Ltd.** (TSX: CNQ)(NYSE: CNQ). The two companies both have operating costs well below $40 per barrel, and have very long-life projects.

Suncor has a couple of other advantages. The company makes nearly as much money from refining and marketing as it does from the oil sands. So an investment in the company isn't really an all-in bet on oil prices. Secondly, Suncor's balance sheet is incredibly strong, with net debt at only 0.7 times cash flow.

Meanwhile, Canadian Natural has its own advantages. The company has earned a reputation for fantastic cost control and smart capital allocation. So in this environment, it is likely to outlast its competitors, and may pick up some cheap acquisitions along the way. And like Suncor, Canadian Natural has a very clean balance sheet, with net debt of only 1.4 times EBITDA.

CATEGORY

1. Energy Stocks
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2. NYSE:SU (Suncor Energy Inc.)
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