Don’t Be Afraid of Oil Producers Cutting Budgets

Description

Another day, another round of spending cuts. **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) announced it will be reducing its capital expenditure to $1.9 billion. Just like I had predicted in early December, the news comes less than two months after the company announced its first round of cuts due to low oil prices. Last year, Cenovus spent $3.1 billion on capital expenses – that’s 14% higher than this year’s budget.

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I’ve lost count of the number of companies that have cut their spending budgets, slashed dividends, and even reduced their workforce. And while all this seems scary, investors should try and look at these moves positively. Trimming one’s budget is essential given the current oil environment. Canadian companies seem to be preparing for the worst and are taking a cautious outlook as the supply of oil increases every day. There seems to be no immediate end in sight to this oil price war.

However, what investors must understand is that despite the spending cuts, production levels are intact. These budget cuts are essential to keep balance sheets healthy. In the case of Cenovus, the $700-million spending cut is an expenditure that can be deferred until crude prices recover. The company still intends to maintain its production levels since its cost of production is low.

Cenovus has great assets in the business and had operating costs of less than $15 per barrel, according to its third-quarter numbers. This gives the company enough room to cope with a $44 oil market environment. Moreover, the company’s Christina Lake and Foster Creek projects are almost complete and the company only needs oil to be around US$40-45 per barrel to earn about a 9% return on investment.

I don’t expect any of these cuts to stop anytime soon, not for Cenovus or for other oil producers. This *must* happen if companies are to survive the weak energy market. And investors should remember to focus on the long-term consequences of these decisions instead of fretting about the slew of cuts.

Cenovus currently has a yield of about 4.3%. The company does not plan to cut its dividend anytime soon, but I expect it to make a revision if oil prices keep deteriorating.

Should investors buy?

Like most people in the industry, I wouldn’t recommend buying into the energy sector just yet. It would be wiser to stay on the sidelines right now and see where oil lands before entering the space again.

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