



3 Ways to Play the Heavy Oil Rally

Description

The increase in prices of Canadian heavy oil have been nothing short of staggering since mid-March. On March 17th heavy oil (represented by the Western Canadian Select benchmark) was only US\$30 per barrel. As of May 13th the price was nearly US\$53 per barrel—a 76% upside.

Western Canadian Select (WCS) has also been outperforming other crude benchmarks. WCS has rallied nearly double that of the popular light crude Western Texas Intermediate (WTI) benchmark since mid-March, and has nearly tripled the performance of the international Brent crude benchmark. The result is that the differential between WCS and WTI—a popular measure of the degree to which Canadian crude is discounted—is only US\$7.56, the lowest since 2010.

Let's take a look at why prices have appreciated so much, and how investing in heavy oil weighted names like **Canadian Natural Resources Ltd.** ([TSX:CNQ](#))([NYSE:CNQ](#)), **Baytex Energy Corp.** ([TSX:BTE](#))(NYSE:BTE), and **MEG Energy** ([TSX:MEG](#)) are the easiest way to gain exposure to the cash-flow growth that will come from WCS increasing.

A quick look at heavy oil and reasons behind the price increase

What is heavy oil? Heavy oil refers to a range of oils that have a high degree of viscosity, and generally do not flow well. These types of oil can range from the consistency of syrup for the lighter forms of heavy oil, to the consistency of peanut butter for extra heavy oil, or bitumen. WCS represents an extremely high-quality form of heavy oil, and other heavy oils are priced at a premium or discount to it.

Bitumen is the heaviest form of heavy oil, and it is extremely thick and cannot move through a pipeline. As a result, it must be diluted, and this diluted bitumen typically trades at a large discount to WTI due to the fact that it is of lesser quality, and is much more expensive to refine into higher-value refined products, requiring specialized equipment and much more energy.

This quality discount is the a major reason behind why WCS trades lower than WTI, but the other major reason is the fact that WCS has very poor access to markets where there is demand for the product, namely the U.S. Gulf Coast, where there is enormous heavy oil refining capacity.

This has slowly been changing, and increased market access has been behind the heavy oil boom. **Enbridge** recently completed its 580,000 bpd Flanagan South project, which connects the Enbridge mainline system in Canada to the major oil marketing hub in Cushing, Oklahoma, and in January, the 850,000 bpd Seaway pipeline connecting Cushing to Gulf Coast refineries opened, providing access for Canadian heavy oil.

These producers are poised to benefit

The best way to gain exposure to this trend is obviously to find producers that have a large portion of production that comes from heavy oil, but it is also important to choose high-quality producers.

Canadian Natural Resources is an essential way to play the heavy oil rally because it is Canada's largest heavy oil producer, with 37% of its overall production coming from heavy oil. Canadian Natural Resources is also the largest contributor of the specific WCS blend, comprising half of its heavy oil production. Since WCS is the highest-quality heavy oil blend, Canadian Natural Resources can realize premium prices.

Baytex Energy Corp. is also an excellent way to play the increase in heavy oil. Baytex currently receives about 43% of its production from heavy oil. While Baytex may receive lower pricing on its heavy oil than Canadian Natural Resources, it has much lower operating costs (only \$10.75 per barrel) because it does not have oil sands assets, which are far more costly to produce.

Finally, MEG Energy is undoubtedly the best way to get pure exposure to heavy oil. Currently 100% of MEG's production comes from heavy oil, and analysts at **TD Bank** estimate that a US\$5/bbl increase in WCS prices would add an enormous 40% to cash flow. With MEG, investors also benefit from the lowest oil sands breakeven price in the industry.

CATEGORY

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1. NYSE:CNQ (Canadian Natural Resources)
2. TSX:BTE (Baytex Energy Corp.)
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Date

2025/08/26

Date Created

2015/05/27

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