Does Cameco Corporation Belong in Your Portfolio?

Description

Cameco Corporation (TSX:CCO)(NYSE:CCJ) has been a frustrating stock to hold over the past four years, but loyal investors could soon be rewarded for their patience.

Here's why.

Market conditions

Cameco provides about 16% of the world's uranium from its mines in the U.S., Canada, and Kazakhstan.

Prices for the commodity have been weak ever since the 2011 nuclear reactor disaster in Japan. Before the tsunami hit the Japanese coast, uranium traded for $70 per pound. Today the price lingers below $40.

Many of the world's producers are not profitable at the current market price, and others are merely able to cover their costs. The prolonged nature of the slump has forced mining companies to delay or even cancel expansion projects in an effort to preserve cash.

At the moment, the market is in an oversupplied state despite the cutbacks because secondary supplies are filling demand gaps. But that source is drying up, and the market could be looking at a supply squeeze in the coming years.

Supply issues

Cameco expects more than 80 net new reactors to go into service over the next decade. There are 64 new facilities already under construction, and countries like India and China plan to ramp up their use of nuclear energy as they rush to meet the growing demand for electricity.

The end result will push uranium demand from the current level of 155 million pounds to 230 million pounds by the end of 2024.

As demand rises and secondary supplies fall, higher prices will eventually push mining companies to expand production, but they might not be able to get the projects up and running fast enough, and that means the market could be headed for a supply shortage.

Price improvements

Uranium prices are still under pressure because most utilities get the majority of their supply on long-term contracts. With spot prices at such low levels, power companies have little incentive to negotiate new deals because they are filling their demand gaps with cheap product from the secondary market.

Once supply starts to get tight, the energy companies will push to sign new deals again in order to avoid getting caught out by a price spike. Once that trend picks up speed, prices should move even higher.

Earlier this year, Cameco signed a new five-year deal to supply India with seven million pounds of uranium, so the process of moving to new long-term contracts might actually be in its early stages.

Earnings strength

Cameco's management team has done a great job of controlling costs through the downturn, and the company remains profitable. In the second quarter Cameco earned $0.22 per share.

The company is one of the lowest-cost producers in the industry, and its Canadian resources are some of the highest grade on the planet.

CRA battle

One item to keep an eye on is the company's battle with the CRA regarding taxes on revenue earned by Cameco's foreign subsidiaries. If Cameco loses the case, it could be on the hook for more than $800 million. A decision is not expected before 2017.

Should you buy?

The long-term prospects for the industry look promising, and Cameco is well positioned to benefit when the market finally improves. The CRA risk is well known and likely priced into the stock. At this point, the upside potential probably outweighs the downside risk. If you have a contrarian style, it might be worth starting a small position before the market turns.

CATEGORY

1. Investing
2. Metals and Mining Stocks

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