Why Oil Investors Should Look at Cameco Corporation

Description

With oil stocks trading so low these days, many portfolio managers are piling in, and all of them have the same logic.

As the thinking goes, oil trades well below the all-in cost of production. So supply will have to fall eventually, causing prices to rise until the market is balanced. Thus when evaluating individual stocks, you should look at their earnings power at these higher prices. Alternatively, you could measure how much it would cost to replace that company's assets. Either way, you should reach roughly the same number.

As long as you're willing to be patient, you can hold these stocks until the market comes into balance. Sounds simple, right?

Well, unfortunately, it's not that easy. To understand why, let's take a look at one stock that has a lot in common with oil companies: **Cameco Corporation** (TSX:CCO)(NYSE:CCJ).

Cameco: a long waiting game

Cameco has been struggling with low uranium prices ever since the Fukushima disaster in March 2011, which led to a shutdown of all nuclear power in Japan. The company's stock declined by about 50% that year and hasn't recovered since.

To put this in perspective, uranium prices of US$60-70/lb are needed to justify new supply additions. The current price is stuck under US$35. Yet supply has held up remarkably well throughout the downturn.

There are some reasons specific to the uranium industry. For example, there is a large secondary market from uranium enrichment plants. But when looking at the big picture, there are some very familiar reasons why supply has held up.

The biggest one is game theory: no one wants to be the first one to cut production, just to see competitors benefit. Furthermore, shutting down production, only to restart it later, is extremely expensive. So companies prefer to simply accept a loss, while hoping their balance sheet will hold up.

Currency is another factor. Certainly the decline in the Canadian dollar helps Cameco. But other currencies have declined even further, and this is especially relevant in the uranium market. Kazakhstan is the world's largest uranium supplier, and that country's currency has depreciated by more than 37% vs. the Canadian dollar over the past 12 months. That makes uranium supply even cheaper in that country.

This story should sound very familiar to energy investors.

Light at the end of the tunnel?

There is some hope for Cameco. Japan is slowly restarting its nuclear program, which could finally help propel uranium prices. In the meantime, Cameco has a strong hedging program, a solid balance sheet, and very low-cost operations.

And if you assume that uranium prices reach US$60, Cameco is heavily undervalued. On a replacement value basis, the stock is even more discounted (because of its low-cost operations).

So if you think oil stocks are a good buy, then Cameco should certainly be on your watch list. But watch out. If the uranium market has taught us anything over the past five years, it's that markets never balance as quickly as we think they will.

CATEGORY

1. Energy Stocks
2. Investing

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