What Does Cenovus Energy Inc. Need in 2016?

Description

Hit by the collapse in oil prices, integrated oil company **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) lost 25% of its value last year and is down to just $14.5 billion. A few weeks ago, however, management released its capital budget for 2016, outlining many of the steps it will take to turn the company around this year.

What's in store for 2016?

Capital spending will be much more disciplined

Producing oil is much less profitable these days after a decline of roughly 70% in oil prices in just 18 months. To combat this, nearly every oil and gas company has needed to find cost savings to balance budgets. This year, Cenovus plans to invest between $1.4 billion and $1.6 billion in oil projects, almost 20% less than a year ago. Every single oil-producing asset will see less investment.

While lower spending may limit long-term production growth, it helps keep the company's balance sheet exceptionally clean, something the market is placing a lot of value on in today's market. Cenovus's net debt-to-capitalization ratio is just 13%–considerably lower than its peers that are floating around in the 20-40% range.

Not only is spending on projects expected to come down, but Cenovus should see relief in general corporate expenses as well. A reduction in these costs is typically preferable as they don't strip the company of future profits. Last year corporate-related expenses were down 22%. In 2016 management expects a similar reduction.

But how profitable will oil production be?

No matter how much costs come down, they won't have as big of an impact as the profitability of Cenovus's primary business–the production and sale of oil. Due to the company's hedging programs, however, we make can't get as reliable of a prediction compared with previous years.

For example, in past years, Cenovus was able to hedge a majority of its production, ensuring reliable and predictable profits. For 2016, only 15% of production is hedged, allowing for significant swings in earnings based on changes in oil prices. Wherever oil prices go, expect Cenovus shares to follow.

How high does oil need to go?

Despite low oil prices and a lack of hedging programs this year, Cenovus is well positioned to survive the current bear market. According to CEO Brian Ferguson, “even if Brent crude prices remain in the $40-per-barrel range through 2016, we believe we can continue to fund our sustaining capital program, growth projects that are nearing completion, and our current dividend level.”

Don’t think that $40 a barrel oil will be enough, however. The company’s capital-spending plan factors in roughly $50 a barrel oil. For every $10 increase in oil prices, cash flow increases by a whopping $620 million, so the gap is real and meaningful. This year, due to a lack of hedging, expect shares of Cenovus to go wherever oil goes.

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