Is MEG Energy Corp. a Bargain at Less Than $7 Per Share?

Description

Back in mid-2014, **MEG Energy Corp.** (TSX:MEG) was one of the most attractive stocks in Canada's energy patch. The company had some of the most efficient heavy oil operations in all of Canada and was growing like a weed. CEO Bill McCaffrey had just been named CEO of the Year by C-Suite Energy Executive Awards, and the company was trading for roughly $40 per share.

Fast forward to today and the shares are below $7. This decline has been even larger than for the sector as a whole. So what went wrong, and is the stock priced at a bargain?

Heavy leverage to heavy oil

MEG likes to refer to itself as "a pure play oil sands investment." Back in 2014 this was certainly appealing to investors. Oil was trading for well over US$100 per barrel, Canadian heavy oil wasn't trading at so much of a discount, and Barack Obama was widely expected to approve the Keystone XL pipeline.

Better yet, MEG had some outstanding assets at Christina Lake. Its per-barrel costs were some of the lowest of all heavy oil producers.

But there were some issues beneath the surface. MEG had slightly more debt than some of its peers, and it also had no hedges. Thus the company had very significant exposure to heavy oil prices. And that's turned into a big problem.

A tough spot

Canadian heavy oil trades at a discount for two reasons. First of all, the product is more costly to refine into gasoline. Secondly, transportation costs are higher for heavy oil, especially since the proper refineries are mainly located along the Gulf Coast.

And as oil prices continue to plummet, that discount remains, hurting companies like MEG. To put this in proper perspective, the company needs oil prices of roughly US$46 just to break even (afterfactoring in debt-servicing costs).

That’s a low number for a Canadian heavy oil producer. But in the North American energy market, costs are coming down so quickly that MEG could get left behind. Then all of a sudden its $5 billion in debt will become even more burdensome.

If there’s any good news, it’s that MEG has a lot of flexibility in the short term. The company has a $3.5 billion undrawn line of credit, its debt is covenant-lite, and there are no debt maturities until 2020. So if oil is set for a recovery, MEG may have just enough staying power.

But if we really are in an oil-price environment that will stay lower for longer, then MEG could be in real trouble. If you’re thinking of buying the stock, be careful with this one.

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