Watch Out for Impairments From These 2 Energy Giants

Description

As Canada's energy companies prepare to release their annual results, analysts and investors are bracing for some big asset impairments. And those impairments could have some big consequences–once those assets are written down, debt ratios will rise, which will also increase borrowing costs. Moody's Investors Service is anticipating this, and has already put a slew of energy companies on notice for a potential downgrade.

We take a look below at how this will affect two companies: **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG) and **Encana Corporation** (TSX:ECA)(NYSE:ECA).

Crescent Point

Crescent Point entered 2015 in relatively good shape. Its net debt load of $3.1 billion was only 21% of total capitalization and only 1.3 times its funds flow. But over the first nine months of the year, the company's debt load increased by $1 billion, mainly because of low oil prices, a big acquisition, and high dividend payments.

Meanwhile, Crescent Point incurred some small impairment charges. But its assets (as of September 30) are valued assuming an average WTI oil price of US$55 in 2016 and US$70 in 2017. Clearly, more impairments are warranted.

So how will this affect Crescent Point? Well to start, let's apply another 20% impairment to Crescent Point's remaining production assets. Doing so would lift its senior-debt-to-capital ratio from 0.31 to roughly 0.4. On top of that, one has to figure the company has increased its debt load since September, which would lift up the ratio even more.

This matters because Crescent Point has a debt covenant which states that the ratio must stay below 0.55. I'm not saying the company is in danger of breaching it, but if oil prices continue to languish, then it will certainly become part of the conversation. You should be well prepared.

Encana

Encana has suffered even more than Crescent Point during the downturn. The struggling energy giant made a big acquisition in the summer of 2014, right before oil prices crashed, and this has left its balance sheet in terrible shape.

Fortunately, Encana uses a different metric for its covenants, a debt-to-adjusted-capitalization ratio, which increases the denominator by $7.7 billion, adjusting for some write-downs made when the company adopted U.S. GAAP.

This ratio stood at 0.30 on September 30, well short of the 60% limit in Encana's covenants. And because this $7.7 billion figure doesn't change from quarter to quarter, the ratio won't change too much either, even with further write-downs.

So even though Encana will probably incur more impairments, the company is not really in danger of breaching its covenants. Yet this is still a very levered company, and it could run into a lot of trouble if oil prices don't recover. Shareholders should once again be very careful.

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