Why Did Moody's Cut Encana Corporation and Cenovus Energy Inc. to Junk Status?

Description

It's been more than six years since **Encana Corporation** (TSX:ECA)(NYSE:ECA) created **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) by spinning out its oil assets. But on Thursday they both suffered a very similar fate: their debt rating was cut to junk status by Moody's Investors Service.

Moody's now has a rating of Ba2 for both Encana and Cenovus, two notches below investment grade status. Oddly enough, S&P continues to have an investment grade rating for both companies.

So why exactly is Moody's so pessimistic about these companies?

Cenovus

"The downgrade of Cenovus reflects the material decline in its cash flow and significantly weakened leverage and interest coverage metrics in the current oil price environment in which its cost of production is above its realized prices," said Terry Marshall, Moody's senior vice president.

Let's look at each of his points in turn. First of all, Cenovus's cash flow decreased by 51% in 2015 relative to the year before, which is not surprising given the decline in oil prices. Unfortunately though, the company's cash flow wasn't even enough to cover the capital budget.

Cenovus has taken a number of steps to shore up its financial condition. The dividend was cut by 40% last year and by another 69% in January. The company has slashed its capital budget multiple times. Royalty assets were sold to the Ontario Teachers' Pension Plan, and new shares were issued. To top it all off, the company cut its workforce by 24% last year, and more cuts are on the way.

These steps had a big effect. Cenovus's net debt declined from $4.6 billion to $2.4 billion. And its net-debt-to-adjusted-EBITDA ratio was only 1.2 times in 2015, the same as in 2014.

But here's the problem: oil prices averaged roughly US$50 per barrel last year, and Cenovus still generated negative cash flow. So with US$30 oil, the company is clearly unable to cover its all-in costs of production. This is without doubt wreaking havoc on Cenovus's leverage ratios as well. And that is why Moody's has acted in this way.

Encana

Mr. Marshall had very similar comments to make about Encana: "The downgrade reflects the material decline in Encana's cash flow that we expect in 2016 and 2017 and resultant weak cash flow-based leverage metrics."

Encana is in even worse shape than Cenovus, mainly due to the takeover of Athlon Energy in the summer of 2014, right before oil prices collapsed. The company's debt-to-debt-adjusted-cash flow ratio surged from 2.1 times at the end of 2014 to 3.1 times by the end of September. Given the further deterioration in oil prices since then, the company is in even rougher shape now, despite a US$900 million asset sale.

So if you're looking for an energy company to invest in, make sure you don't put too much money in these companies. After all, if they default on their debt, then the stock would go to zero. Be sure to tread carefully.

CATEGORY

1. Energy Stocks
2. Investing

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2. TSX:CVE (Cenovus Energy Inc.)

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