What Will Stop Encana Corporation's Slide?

Description

Encana Corporation (TSX:ECA)(NYSE:ECA) was down as much as 10% on Friday after **Moody's Corporation** cut the company's debt rating to junk. Encana's bonds now trade at just 63 cents on the dollar, and its stock is down 75% over the past 12 months.

What can stop the company's consistent, downward slide that's lasted for over 18 months?

Only oil prices

The overwhelming reason for Moody's rating downgrade is low oil prices, which have remained well under $50 a barrel for over 12 months. According to *Bloomberg*, "the ratings move comes as analysts and energy companies brace for the potential of lower prices for longer … Moody's reduced its outlook for oil in January for the second time in just over a month, citing a persistent global glut and weaker demand in China."

Quite simply, only higher selling prices can end the slide.

Encana's financials are deteriorating to a point where it's nearly impossible to find meaningful cost reductions anywhere close to stemming the tide of low prices. Drilling and completion costs (a major source of ongoing capital expenditures) are some of the best in the industry. While that helps limit losses in today's environment, it also means there aren't many easy ways to lower costs.

Capital expenditures in total fell to just $473 million last quarter from over $730 million in each of the previous three quarters. Still, the company posted negative free cash flow. At this point, Encana's fundamentals will slowly erode unless the oil market stabilizes.

How long until oil rebounds?

Fellow fool Matt DiLallo recently wrote a piece highlighting what **Suncor Energy Inc.'s** management team thinks about the future of oil prices. While they believe it will eventually end up "somewhere in the $70-90 rate," even these experts admit there's "a question of when the long term actually arrives."

Encana doesn’t have any debt maturities until 2019, so along with a healthy hedging program for 2016, it shouldn’t have any issues surviving another 12 or even 18 months of low prices. The issue is that the company’s financial health will be deteriorating along the way. If a rebound doesn’t occur for another 20+ months (the length of the current downturn), Encana may simply find it impossible to service its $10.6 billion in total liabilities.

For example, despite using an assumption of $50 oil, the company’s 2016 forecast calls for $1.0-1.2 billion in incoming cash flow, but $1.5-1.7 billion in capital expenditures. For every $10 per barrel swing in oil, management anticipates cash flow moving by $170 million. With oil at $30, capital expenditures could easily comprise 200% of incoming cash flows this year.

Unless you believe oil will rebound strongly this year, it might be a better idea to stick with energy companies that can withstand a prolonged downturn and capitalize when the market stabilizes.

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