Encana Corporation and Cenovus Energy Inc. Join Canada's Growing Junk Problem

Description

Earlier this month **Canadian Oil Sands Ltd.** (TSX:COS) had its credit rating cut below investment grade by **Moody's Corporation** (NYSE:MCO). In doing so, it pushed the company's credit rating into what's known as junk territory, making it the first large Canadian oil producer to receive a junk rating in the last decade.

However, in a sign that industry conditions are really worsening, Canadian Oil Sands was joined last week by both **Encana Corporation** (TSX:ECA)(NYSE:ECA) and **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE), which likewise had their credit ratings cut below investment grade.

Credit ratings 101

There are a number of different levels of credit, each signifying the level of risk that a bond investor is taking on when buying certain bonds. For example, prior to being downgraded both Encana and Cenovus Energy were rated Baa2 by Moody's, while Canadian Oil Sands was Baa3, which meant they were all in the lower-medium grade level of credit worthiness. Baa3 is the last level of investment grade, while Baa2 was one level above that.

To put it another way, it meant that these companies had a decent ability to meet their financial obligations; however, if economic conditions worsened, it would weaken their financial capacity to meet their future obligations.

Well, industry conditions have worsened, which is why all three have been cut below the critical investment grade line. Cenovus Energy and Encana's debt is now rated Ba2, while Canadian Oil Sands was cut a notch below to Ba3.

These levels all fit under the banner of being non-investment grade speculative, implying that there is an increased risk because all three face major uncertainties and could have trouble meeting their financial obligations if conditions in the oil industry continue to worsen.

Why were these changes made?

Basically, Moody's is growing increasingly concerned with the impact that the oil industry's downturn will have on the financial health of these companies.

For example, even though Canadian Oil Sands is being acquired by **Suncor Energy Inc.**, it has a very high cost basis, which Moody's expects will cause it to have "very high leverage and weak interest coverage in 2016 and 2017 in the currently very weak oil price environment."

In other words, given current industry conditions, Canadian Oil Sands is going through a period when its financials will be stressed should current prices persist.

Similarly, Encana and Cenovus Energy are expected to see a "material decline" in cash flow in 2016 and 2017, and that resulting weak cash flow will tighten their leverage metrics. That suggests the companies are not going to have much financial wiggle room over the next couple of years due in part to their debt obligations.

Cenovus is in a particularly tight spot right now because it not only has $4.7 billion in debt but, according to Moody's, its "cost of production is above its realized prices." What that means is that it costs the company more to produce oil than it's bringing in.

What do these downgrades mean?

In essence, what Moody's is saying is that there is a growing risk that large producers might not be able to pay their bills if conditions grow worse and stay that way. Further, with credit ratings moving below investment grade, it will be much tougher and more expensive for these companies to borrow money in the future if they need the cash. That will really limit their financial flexibility going forward.

These downgrades are another sign that conditions within the industry have really gone from bad to worse over the past few months. With oil in the low $30s, it has become almost impossible for producers to even maintain their production rates. Instead, the focus is just making it through the downturn without any further damage to their balance sheets.

CATEGORY

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1. NYSE:CVE (Cenovus Energy Inc.)
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