



Why Did Encana Corporation Drop 10%?

Description

Encana Corporation (TSX:ECA)(NYSE:ECA) released its first-quarter earnings report on Tuesday. Results fell short of expectations, and following the report, shares dropped 10%. While the company has made strides in cost-cutting and production efficiencies, stagnating natural gas prices continue to hit the company's bottom line.

Since February, shares have roughly doubled. Do the latest struggles signal an end to the rally?

Getting away from gas

The recent struggles are of no surprise. While oil has grown from 5% of production to nearly 20% in just a few years, natural gas still constitutes over 75% of Encana's output. The company's management team hopes that oil will become the major driver of future profits, but for now, natural gas dominates.

Historically, Encana's share price has been heavily influenced by the cost of natural gas. This past quarter, the company realized unhedged gas prices of \$1.73 per thousand cubic feet, below nearly all Wall Street estimates. For Encana to realize its forecasted returns on many of its projects, it would need gas prices of about \$3 per thousand cubic feet.

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While the market is selling the stock on current natural gas fears, long-term investors can capitalize on Encana's long-term transition towards oil. Management has focused capital spending on just four core areas (Eagle Ford, Permian Basin, Montney, and Duvernay).

Because these projects are oil rich, the company's production profile should naturally shift away from natural gas. Oil generally has better market conditions and, based on Encana's cost of production, would come with higher profit margins. Its four primary assets are projected to have 30% returns at \$50 oil.

The natural shift towards oil should be inevitable, but Encana could speed up the process through

strategic asset sales. Last month, *Reuters* reported that Encana is “exploring the sale of more non-core assets in the United States and Canada that could be worth about \$1 billion.”

The company already sold \$2.8 billion in assets last year, but sources now say that it’s open to offers on every one of its non-core assets. If Encana targets selling natural gas properties, it could transform into an oil producer nearly overnight. Depending on the price it gets for its asset sales, shares would likely receive a higher valuation premium.

How long will this take?

Despite the long-term story, Encana’s production profile is still highly leveraged to natural gas, hence the recent 10% drop off weak selling prices. The transition towards oil production should take years barring any transformational divestiture. Still, the company has plenty of factors that should aid in its transition, including no significant debt maturities over the next few years, a renewed line of credit, and operating cost savings that free up excess capital.

Encana has the tools necessary to complete its shift away from natural gas, but it will take years to achieve. If you’re looking for something with immediate potential, check out our rare “double down” stock below.

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Author

rvanzo

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