



Encana Corporation Hits \$10: Time to Double Down?

Description

Encana Corporation (TSX:ECA)(NYSE:ECA) has more than doubled since its lows set earlier this year. There have been a few factors a play. First, natural gas prices have been spiking—up over 50% since March. Second, management has been executing its plan to transition the business towards lower-cost, primarily oil-producing fields.

How long will these positive tailwinds last?

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Management's master plan is still in its infancy

For years, Encana's management team has attempted to move away from natural gas towards oil, where profitability metrics are much higher. In just three years oil has grown from 5% of production to nearly 20%. To speed up the process, it has turned to selling off assets that are heavily exposed to natural gas production.

In 2015 the company sold \$2.8 billion in assets. Last month, it announced another \$625 million deal to sell assets in northwestern Alberta. Because over 90% of the production at those wells was either natural gas or natural gas liquids, the market loved the deal, sending shares higher.

Still, the company has a long way to go until investors will be willing to view it as an oil company.

The strategy of offloading assets may have become more difficult as well. In June the Alberta Energy Regulator opted to toughen rules that make it more difficult to complete mergers and acquisitions in the province. A slowdown in deal could threaten Encana's momentum given that asset sales represent the quickest way to transform itself into an oil company.

Natural gas prices are a major boon

In March natural gas prices bottomed at about US\$1.70 per MMBtu. This week the commodity closed at about US\$2.70 per MMBtu. While the rally in natural gas prices has been sudden, there are a few

reasons to believe it will continue.

Last year, the EIA expected the supply glut to wind down over the course of this year. However, weather shifts have caused many analysts to call for a deficit by 2017. Approximately 50% of U.S. and Canadian households use natural gas for heating and cooling, so extreme temperatures help push up prices.

Tightening supply should have major effects on Encana's business. After exporting massive supplies of natural gas from 2012 to 2015, the EIA now expects the U.S. to become a net importer by 2017. For Canadian producers like Encana, this represents a giant opportunity. Additionally, since 2007 the number of natural gas rigs in North America has fallen by over 80%. Lower rig counts are a necessary component to restricting excess supply.

Long road ahead

While Encana shares have deservedly experienced a big boost this year, the structural issues it faces will persist for years. Sure, the U.S. may turn into a net importer of natural gas next year, but once rig counts are brought online again, cheap sources of fracking should put a cap on pricing gains. Additionally, management will still need years to diversify the business away from natural gas.

If you're looking to invest in Encana, you must be bullish on its ability to complete a multi-year transition in a still-difficult operating environment. Buying and holding remains the best option.

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