Canadian Natural Resources Limited: Why Is Cash Flow Plunging?

Description

The second quarter was a mixed bag for **Canadian Natural Resources Limited** (TSX:CNQ)(NYSE:CNQ).

Earnings per share came in at -$0.19, beating expectations by $0.01. The beat was largely due to a successful cost-cutting program. In the first half of 2016, Canadian Natural realized operating cost savings of roughly $430 million when compared with the previous year. That represents a 14% drop in overall operating costs per barrel of oil equivalent.

While many investors will look at the earnings beat and feel optimistic, a deeper dive into the quarter reveals some mixed messages. Notably, cash flow from operations fell to $938 million from $1.50 billion a year ago–a 38% decline.

What's going on?

Operating costs may be falling, but so is the main driver of profits: production. Output for the quarter came in at 784,000 barrels a day, down 7% compared with last quarter and down 3% compared with last year. Management described the results as "slightly negative," blaming lower production on unplanned outages. Falling output and lower realized prices forced revenues down to just $2.55 billion–a 25% decline from last year.

Looking beyond this quarter, however, potential upside exists. Even the company is describing itself as "nearing an inflection point."

Two major projects, expected to be finished over the following 12-24 months, will boost current output considerably. Its Horizon bitumen extraction project, with stage two finishing next year, is expected to produce 126,000 barrels of oil per day. The Kirby, Primrose, and Pelican Lake oil sands projects, which will all finish by 2018, are expected to produce 180,000 barrels of oil per day. That's would provide a huge jump from current levels.

Investors need not worry about the plunge in cash flow last quarter as the future driver of profits will come from projects that aren't yet online. Plus, once those projects are finished, capital expenditures should fall by billions of dollars, potentially resulting in massive free cash flow potential.

This potential caused **Royal Bank of Canada** to deem Canadian Natural its “top pick,” with analyst Greg Pardy commenting that the stock “offers investors the best of all worlds,” including free cash flow generation, production growth, and leverage to rising oil prices. If oil climbs to US$70 a barrel, Greg Pardy anticipates cash flow hitting $5.4 billion–roughly 12% of the company’s current market cap.

Should you be buying?

Canadian Natural’s business strategy comes with plenty of risks. Many of its projects forced it to accumulate billions in added debt and require higher oil prices to justify the expense.
Meanwhile, shares are nearing highs set in 2014, when oil prices were above $100 a barrel. Much of the upside may already be priced in.

Still, the company’s management team, which currently owns over $1.4 billion, or 2.6%, of outstanding shares, hasn’t sold any stock since 2014. If you’re inclined to bet with management, you should continue to hold shares. The valuation is looking a bit fully priced, however.

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Date
2025/08/26
Date Created
2016/09/06
Author
rvanzo