



These 2 Oil Names Are About to See Explosive Free Cash Flow

Description

Investing in the oil space can be complex as investors need to balance knowledge of oil market fundamentals with knowledge of a producer's asset base, cost structure, balance sheet, and production growth prospects. Luckily, there's one measure that can help investors quickly judge the quality of an oil producer: free cash flow.

Free cash flow is simply a company's operating cash flow (which is basically the cash profit a company earns) minus its capital expenditures, or how much it spends to both maintain and grow production. Capital expenditures go towards exploration, drilling, and completion of new wells, or to the development of new mines in the oil sands space.

Free cash flow is an excellent way to tell how much cash a firm is generating, or how much it has left over after all of its capital and operating expenses are paid for. Free cash flow is a huge driver of shareholder returns.

A report by **TD Bank** looked at the relationship between free cash flow and total returns for oil and gas names and found that over a five-year period, there was a very strong correlation between these two factors (the correlation was 89% with 100% implying the two factors move perfectly in tandem with each other). This shows very clearly that the higher the free cash flow, the higher the returns over time.

Why does free cash flow drive higher returns?

There are several possible reasons. Firms with excess cash can use that cash to invest in short-term production growth or in activities to secure longer-term growth. This can be done through organic growth (drilling and completing new wells), through acquisitions, or through investing in exploration. Firms can also use excess cash flow to pay down debt and strengthen their balance sheet, or to grow dividends and/or buy back shares. These activities are all shareholder friendly.

The fact that a firm has excellent levels of free cash flow will also likely lead to the market rewarding that firm with a higher valuation than its peers. Plenty of free cash flow means a firm probably has a low-cost, high-quality asset base and a management team that is allocating capital efficiently.

For investors in Canada looking for names with good free cash flow prospects, these two are excellent places to start.

Crescent Point Energy Corp. (TSX:CPG)(NYSE:CPG)

Crescent Point benefits from an extremely high-quality, high-returning asset base (almost all of its assets pay back their capital costs in under two years and about half under one), and this is a primary driver of its positive free cash flow outlook. Crescent Point's 2016 capital program guidance was originally set at \$950 million, which Crescent Point stated it could fund with oil prices of only US\$35 per barrel.

Now, with higher oil prices, Crescent Point is in a position where it will see free cash flow for the year, and the company has responded by increasing its capital expenditures to \$1.1 billion.

Just how much free cash flow is Crescent Point expecting over the next several years?

Analysts at TD Bank see Crescent Point generating cumulative free cash flow of \$3 billion by 2020 (assuming US\$60 in 2017 going to US\$70 by 2020).

Canadian Natural Resources Limited ([TSX:CNQ](#))([NYSE:CNQ](#))

In TD Bank's 2014 study on free cash flow, Canadian Natural ranked number one in terms of free cash flow in the list of companies they analyze. Today, Canadian Natural's free cash flow outlook is just as strong.

Canadian Natural's free cash flow strength comes from its oil sands mining focus (oil sands operations require very little capital to maintain production). More specifically though, Canadian Natural's Horizon mine has the lowest breakeven cost in Canada (it is currently undergoing an expansion and is expected to have operating costs of less than \$25 per barrel, or US\$19 per barrel).

As the Horizon expansion continues, Canadian Natural should see impressive free cash flow with a free cash flow yield of 1.5% this year at US\$45 per barrel and 9.3% next year at US\$60 per barrel, according to **Bank of Nova Scotia**.

CATEGORY

1. Energy Stocks
2. Investing

POST TAG

1. Editor's Choice

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1. NYSE:CNQ (Canadian Natural Resources)
2. NYSE:VRN (Veren)
3. TSX:CNQ (Canadian Natural Resources Limited)
4. TSX:VRN (Veren Inc.)

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Author

amancini

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