Why the Rally in These 3 Canadian Natural Gas Stocks Is Just Getting Started

Description

U.S. natural gas prices are up over 100% from the lows set in March (to $3.26/mmBtu), and there is a very good chance prices could end up well above $4/mmBtu. While many investors are skeptical of this (based on consensus natural gas price estimates), this skepticism gives bullish investors an opportunity to buy natural gas names at lower levels today before investors on the sidelines enter.

Currently, the EIA sees natural gas prices averaging $3.07/mmBtu in 2017 (well below current levels). **Bank of Nova Scotia** sees $3.30/mmBtu for 2017 in its base-case scenario, and in its most-bullish-possible scenario, sees prices rising to US$3.68/mmBtu for the year.

Most investors still have a bearish outlook on natural gas due to the idea that natural gas production will grow in response to higher prices (the EIA sees natural gas production growing by 3.7 billion cubic feet per day in 2017, up from 77.51). Here's why this idea may be overly optimistic, and how investors can profit.

U.S. natural gas production will not spike as much as many think

Recently, energy analyst Art Berman published a report wondering where the EIA's projected 3.7 billion cubic feet per day of natural gas production will come from, especially given its price forecast of only $3.07/mmBtu for the year. Berman cites the fact that the best shale gas areas need $4/mmBtu to break even, and many other areas require $6/mmBtu to break even.

Even the highly economic Marcellus region requires prices about $3.50 to break even according to **Encana,** and at the EIA's projected natural gas prices for 2016, only producers in Deep Basin and Montney could break even. Given low prices, most producers are just planning on completing previously drilled wells in 2017 with little room to spend capital on exploring new areas and drilling new wells.

At the same time, it is estimated that close to half of producers have hedged production at nearly $3 per mmBtu, which means that even if natural gas prices due continue to rise, producers will not see much excess cash flow because the hedge contracts would begin to lose value as the price rises above $3 per mmBtu, offsetting any gains in cash flow. This will also lead to much lower than expected production.

At the same time, while last winter was abnormally warm due to El Nino, there is currently a 70% chance of La Nina developing, which would result in a much colder winter and much higher natural gas demand. Warmer than normal temperatures are expected in the very short term, which may be keeping investors on the sidelines as they're forgetting about the longer-term picture.

Canadian names are a smart way to play the rise

Canadian natural gas receives a discount to U.S. natural gas, which also means it stands to do better than U.S. natural gas as prices recover, provided the discount remains the same or shrinks. Canadian natural gas is highly economic, and companies that are based in the Montney region have a breakeven price below US$3/mmBtu—the lowest in North America.

At the same time, **TransCanada** has recently offered Canadian natural gas producers a nearly 50% reduction in tolls, which should allow Canadian producers based in the west coast to effectively compete with east coast Marcellus producers that are closer to key demand markets. This should mean strong Canadian imports to the U.S.

Three Canadian names are best set to profit from this trend: **Birchcliff Energy Ltd.** (TSX:BIR), **Tourmaline Oil Corp.** (TSX:TOU), and **Kelt Exploration Ltd.** (TSX:KEL).

Tourmaline is the largest of the group with 86% gas production and only 31% of production hedged. Tourmaline has low debt levels and is the fifth-largest producer in the low-cost Montney region.

Kelt Exploration and Birchcliff are also good options with 62% and 72% natural gas production, respectively, and both have Montney exposure.

CATEGORY

1. Energy Stocks
2. Investing

TICKERS GLOBAL

1. TSX:BIR (Birchcliff Energy Ltd.)
2. TSX:KEL (Kelt Exploration Ltd.)
3. TSX:TOU (Tourmaline Oil Corp.)

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Date
2025/08/26
Date Created
2016/10/20
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