



## Why Canadian Natural Resources Limited Will Surprise Investors to the Upside

### Description

Back in June, **Royal Bank of Canada** announced **Canadian Natural Resources Limited** ([TSX:CNQ](#)) ([NYSE:CNQ](#)) was their top energy pick, stating that Canadian Natural offered “the best of all worlds.” RBC referred to the company’s projected 8% CAGR production growth through to 2020, an explosive free cash flow profile, and a reasonable balance sheet (expected 2017 debt to cash flow of 1.8 at US\$54 oil).

Since mid-June, Canadian Natural shares have rallied 20% with the majority of this upside coming over the past month. While Canadian Natural is currently trading at about \$44 per share (right into the target price range of most institutions), there is good reason to believe that the market is significantly underestimating this stock and that a move to \$50 or more over the next year is likely.

Currently, Canadian Natural trades at a discount to its peer group of senior independent producers, using a fairly conservative 2017 oil price of US\$54 per barrel. Canadian Natural is currently trading at an enterprise value (net debt plus market capitalization) of eight times its debt adjusted cash flow. This compares to its peer group, which trades at 9.8, and large integrated names, which trade at 8.4.

This discount likely exists because Canadian Natural is seen as a slower-growth name (only about 4% growth seen in 2017 compared to 9% for the group). While Canadian Natural could close the gap with its peer group, it is likely that Canadian Natural may also see cash flow much higher than being forecasted.

### The market outlook on Canadian natural gas prices is likely too low

Canadian Natural is currently the largest natural gas producer in Canada; it gets about 35% of its production from natural gas. This is actually below its peer group (it gets 55% from natural gas), which means that if natural gas prices did better than expected the whole peer group would do better too. Canadian Natural, however, has several competitive advantages in the natural gas area that could see the value gap with its peer group close.

Canadian natural gas (known as AECO) typically trades at a big discount to U.S. natural gas (known as Henry Hub). This is because Canadian natural gas is produced in the WCSB in Alberta and is

extremely far from key demand markets in eastern Ontario and California.

With fast-growing production from the low-cost Marcellus region in the eastern U.S., Canadian production has been displaced, and Canadian gas was simply not able to compete. The end result is that Canadian gas producers have to discount their gas, while at the same time dealing with higher transportation costs and falling natural gas prices in general.

This is about to improve, however, and it is good news for Canadian Natural. **TransCanada** is proposing to reduce tolls on its Mainline (which connects Alberta to Ontario) by half. This gives Canadian producers a major competitive edge back; the reduction in the toll means Canadian Natural can take advantage of the spread between Alberta and Ontario prices, since it will exceed the new transportation costs.

The Marcellus region in the U.S. is facing pipeline constraints, so Canadian natural gas imports should remain strong. At the same time, if there is a colder than expected winter (which is likely due to the La Nina effect), Canadian natural gas could see a huge boost.

Canadian Natural has several major advantages in the natural gas space. Canadian Natural owns pipelines that connect its assets to major pipelines. This lowers Canadian Natural's costs compared to its peers. Canadian Natural also operates in the top two lowest-cost regions in North America by breakeven costs (the Montney and Deep basin), both of which are economic at current Henry Hub prices of US\$3/MMBtu.

Canadian Natural also has operating costs that are (sometimes significantly) lower than its peer group. Given this, Canadian Natural is set to outperform its peers in an environment where Canadian natural gas prices are expected to do well. If U.S. natural gas prices end up higher than they are (and they will because current prices are \$1/MMBtu below the breakeven costs for most producers), Canadian Natural will definitely outperform.

## CATEGORY

1. Energy Stocks
2. Investing

## TICKERS GLOBAL

1. NYSE:CNQ (Canadian Natural Resources)
2. TSX:CNQ (Canadian Natural Resources Limited)

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