Royal Bank of Canada Upgrades Encana Corp.: Time to Buy?

Description

In October, **Encana Corp.** (TSX:ECA)(NYSE:ECA) outlined a new five-year growth plan–complete with updated 2016 guidance. Soon after, both **Barclays PLC** and **Macquarie Group Ltd.** upgraded the stock.

This month, **Royal Bank of Canada** (TSX:RY)(NYSE:RY) followed suit. “We recently signaled that we would add Encana on weakness–and are putting those words into action,” said analyst Greg Pardy after upgrading the stock to “outperform” from “sector perform.”

Today Encana stock is nearly 400% higher than its lows set earlier this year. Is now really the time to buy?

Here’s what to like

When upgrading Encana’s stock, analyst Greg Pardy highlighted the company’s latest growth plan, which will boost its high-margin oil exposure and natural gas condensate production through 2021.

“We believe that Encana has some of the best real estate on the block when it comes to North American resource plays and possesses solid execution capability,” he said.

In its latest five-year growth plan, Encana expects to grow cash flow by 300%, driven by a doubling of profit margins and a 60% increase in total production.

Importantly, Encana is now aiming for a balanced production mix of oil and liquids and natural gas. In just three years, oil has grown from 5% of production to over 20%. This is a notably positive trend considering oil comes with higher profit margins and better market dynamics than natural gas.

There’s reason to believe this trend will continue.

Already, 96% of Encana’s capital expenditures are dedicated to its four core properties: the Permian, Eagle Ford, Duvernay, and Montney basins. Roughly 75% of production already comes from these four regions.

Focusing on just a few regions has some major advantages.

First, Encana is able to focus its spending to lower costs in an already low-cost region. In the Permian Basin, for example, Encana has pushed down drilling and completion costs by 31% from 2015 levels.

Low costs had a big influence on this quarter’s results. On November 4, the company reported net earnings of $317 million, or $0.37 per share, compared to a net loss of $1.24 billion the year prior. Management specifically noted that it reduced costs in the Permian formation by 34% compared with last year. In the Montney formation, it reduced average per-well costs by 33% compared with last year.

Another advantage of focusing on these four basins is that they have relatively high levels of oil. Compared to natural gas, oil typically comes with better profit margins along with a significantly improved supply/demand outlook.

Higher capital expenditures in its core properties will result in oil boosting its share of Encana's output mix. By 2018 natural gas will likely comprise less than 50% of production–down from 82% in 2014.

Fundamentally, Encana is in great shape. The transition towards oil will help drive the impressive financial gains outlined in its forecast. As long as energy prices continue to revert higher, shareholders will continue to benefit.

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