Cenovus Energy Inc.: An Incredibly Cheap Oil Stock

Description

At the end of March, **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) made international headlines when it agreed to spend more than $17 billion to acquire most of **ConocoPhillips's** Canadian assets.

The biggest part of the sale was ConocoPhillips' 50% interest in the Foster Creek Christina Lake oil sands partnership, which is already operated by Cenovus. Once Cenovus integrates that into its existing output, production will hit some 590,000 barrels of oil per day. This will further cement Cenovus as one of Canada's largest crude oil producers.

Cenovus shares plunged on the news for a couple of reasons. Investors weren't exactly in love with the idea of doubling down on the oil sands when crude oil is trading for under $50 per barrel. Western Canadian Select continues to fetch even lower prices than lighter crude; it currently sits at approximately $43 per barrel.

The other reason Cenovus shares fell was because of news the company would issue 208 million new shares to ConocoPhillips to help pay for the transaction and issued 187 million new shares to investors. Investors weren't happy about the dilution nor the discount new shareholders got.

Cenovus shares have continued to be weak. They currently trade hands for $14.64 each on the Toronto Stock Exchange, which is within 1% of their all-time low.

I believe value investors should be paying attention to Cenovus shares. Here's why today is an incredible buying opportunity.

Reserve value

Before the transaction, Cenovus had reserves of 3.8 billion proved and probable barrels with most located in the oil sands. After the deal closes, the company will own 7.8 billion barrels of reserves.

It will have a total of 1.3 billion shares outstanding, which includes the new shares issued to pay for the transaction. Based on the current price of $14.64, this gives the company a market cap of roughly $19 billion.

It will owe approximately $10.5 billion to creditors once the deal closes, and the transaction will use up much of the company's cash hoard. This gives Cenovus an enterprise value of approximately $29.5 billion.

What does this mean? It means an investor getting in today is paying under $4 for each barrel of reserves — $3.78 each, to be exact.

There is no cheaper way to buy oil reserves. **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) has 7.7 billion barrels of oil reserves and an enterprise value of approximately $84 billion. **Canadian Natural Resources Limited** (TSX:CNQ)(NYSE:CNQ) has an enterprise value of approximately $76 billion (once we adjust for its recent oil sands acquisition from **Shell**) and 11.5 billion barrels of reserves.

In short, an investment in Suncor is the equivalent of buying reserves at $10.90 per barrel, and an investment in Canadian Natural is like buying reserves at $6.60 per barrel. Neither compare to Cenovus.

I realize these aren't perfect figures. Suncor has some of Canada's best downstream assets, which skews our numbers. In addition, looking simply at reserves depends heavily on oil prices. Reserves are worth more when the price of crude is higher.

There's more to valuing an oil company than just looking at reserves. Luckily, Cenovus has a number of other things going for it as well, including some of the lowest costs in the region, a solid balance sheet with zero debt due before 2019, and the ability to generate healthy cash flow if crude recovers an additional 20%.

The bottom line

Many Cenovus shareholders are guilty of just looking at the short term with this deal. There's no doubt it weakens the company's balance sheet. Cenovus is taking on debt at the exact moment many energy companies are shedding it.

But ultimately, the strategy is likely to work out when the price of oil recovers. When crude hits $100/barrel again, Cenovus shareholders will look back to this deal and salivate at the cheap reserves acquired today. Investors who get in now should be richly rewarded. We just don't know when.

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