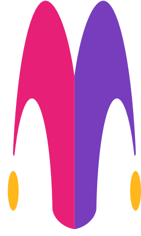

Cenovus Energy Inc.: A Strong Quarter Overshadowed by an Unwanted Acquisition

Description

At the end of March, it was announced that **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) would be acquiring 50% of the FCCL Partnership which **ConocoPhillips** (NYSE:COP) owned, effectively doubling its oil sands production and nearly doubling its bitumen reserves. Management was incredibly bullish on this acquisition for many reasons.

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The production of the assets is expected to be 300,000 barrels of oil equivalent per day. With full-year numbers in 2018, Cenovus will bring in 515,000 barrels of oil across its entire network. Over the next few years, management sees near-term capacity growth reaching 125,000 daily barrels of oil. All told, management believes this will increase adjusted funds flow per share by 18%.

Another reason management likes this acquisition is because it results in significant cost cutting. According to the company's projections, this acquisition will reduce the operating costs per barrel of oil by 16% in 2018; further, it will see a 26% drop in general and administrative costs per barrel of oil. Essentially, management sees a business that will be pumping more oil at a significantly reduced cost.

You'd think that investors would be happy with this, but they're not. The problem is that Cenovus has to raise $3 billion in a common equity deal, which means it will be significantly diluting its investors. Another $3.6 billion will come from cash and available credit.

One investor in particular is trying to stop the deal entirely. Coerente Capital Management Inc., which owns 524,000 Cenovus shares, is arguing that this deal will dilute investors by 47%. It wants the Toronto Stock Exchange to stop the deal until investors have had an opportunity to vote on the acquisition. That's a perfectly fair desire.

Here's the problem…

All of this drama about the acquisition is completely overshadowing the fact that Cenovus actually had a relatively strong quarter. Cenovus increased total crude oil production in Q1 2017 versus the first quarter 2016 thanks to new projects coming online. Further, it decreased its per-unit crude oil operating

costs by 7%. More oil at reduced costs is a great recipe for success.

Cenovus's cash from operating activities was $328 million — a $146 million increase year over year. And, most importantly, it recorded net earnings of $211 million in Q1 2017. In Q1 2016, the company had a net *loss* of $118 million. That's a massive reversal, and in any other circumstance, investors would have been buying up shares on the news.

Yet over the past month, the company has given up 20% of its value, dropping nearly $3.50 a share. While I understand investors are concerned about the dilution, this might be an example of an overreaction by the market. The acquisition, if it is approved and does as well as management believes, could fundamentally change the business and make it far stronger.

That being said, I don't believe you should buy Cenovus just yet. The market is an irrational beast from time to time and could claw away even more value from Cenovus. Therefore, I would wait until things have truly settled before buying. However, a 20% shave is a great chance for investors who are bullish on oil to start getting in to the market. Take advantage of the market's irrationality when things settle a bit, and you could see a quick return.

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