Bullish on Oil? These 2 Names Have 70% Upside if Oil Rallies

Description

Regardless of your personal view on the outlook for oil prices, the massive underperformance of the sector has left a range of names down 20-50% from where they were just a few short months ago. Energy is now the worst-performing sector in the U.S. (down 10% year-to-date) and one of two sectors that are in the red for the year.

The important question is, has the long-term outlook for energy names really worsened by 20-50% since January, as prices would suggest, or is the market making a key error in valuing these names? Oil is currently trading at about $49 per barrel compared to around $53 at the start of the year, and it is difficult to see how a 7.5% sell-off in oil prices justifies a 50% sell-off in some key high-quality Canadian names.

Some of these stocks are trading at the same levels they were last year when oil was in the low US$30s. This weakness implies that energy names are pricing in a nightmare scenario for crude, when in reality the picture is much brighter than many suggest.

The key catalyst for higher oil prices will be the continued draw-down in U.S. petroleum storage (which began in July 2016 and coincides with global storage levels that have been declining over the same period), and the following energy names have tremendous upside of this continues and minimal downside if it doesn't.

Cenovus Energy Ltd. (TSX:CVE)(NYSE:CVE)

Cenovus is probably the poster child for weakness in the energy sector. Currently, Cenovus is down a massive 37% year-to-date (a significant move for a large-cap oil name). In fact, at the current price of $13.50 per share, Cenovus is trading at the same level it was on February 10, 2017, when oil prices were US$27 per barrel.

This level of undervaluation is extreme. The main reason for the weakness in Cenovus (besides the broader sell-off in the energy space and in oil prices) is its recent $17.7 billion acquisition of oil sands and natural gas assets in Canada from **ConocoPhillips**.

The acquisition sees Cenovus gain 100% working interest in its Christina Lake, Foster Creek, and Narrows Lake oil sands assets and acquire a new core area in Deep Basin. What's the problem? The deal is seen as expensive and damaged Cenovus's pristine balance sheet.

The deal sees debt-to-cash flow climb from 0.7 times cash flow in 2018 to three times cash flow. In addition, using strip oil prices (which basically sees US$50 oil out to 2020), these assets are only worth about $12.7 billion, which means Cenovus overpaid.

The deal, however, will double Cenovus's free cash flow (partly due to the fact Cenovus is acquiring low-cost Deep Basin assets and will be selling higher-cost conventional assets), and assuming an even slightly more bullish oil price forecast (US$55-60 per barrel), the deal makes great sense.

Should Cenovus simply trade in line with its peer group in terms of EV/DACF in 2018, it would trade at around $20 per share — 48% above today's levels.

Trican Well Service Ltd. (TSX:TCW)

Trican is a smart way for investors to play the forecasted rise in production coming out of Canada. Trican is an oilfield service provider which offers hydraulic fracturing, among other things, and rising production is good news for Trican shares.

This year is expected to see a massive 60% growth year over year in Canada, and Q1 2017 saw 78% year-over-year growth in drilling activity. Trican recently merged with Canyon Services to create the largest driller in Canada (37% of all frac capacity), and the merger will create major synergies.

In addition, the merger will give the combined company a market capitalization of over $1 billion, which will put it on the radar of large funds. **Bank of Nova Scotia** sees $7 per share for Trican — 90% above today's levels.

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