Cenovus Energy Inc. Is Trading at All-Time Lows: Huge Upside Ahead

Description

While the Toronto Stock Exchange is only about 2% off all-time highs after a monster multi-year rally, shareholders of **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) certainly hasn't participated — the stock recently closed just above $13 per share, which is only slightly off the all-time low of about $12.60 set in February 2016 at the very bottom of the historic collapse in oil prices.

For value investors, this sell-off represents tremendous opportunity with very minimal downside and huge upside. It is a clear example of a market overreacting.

Cenovus is trading near the same level that it was trading at in February 2016, when oil prices were $25 per barrel. Today, oil prices are $45 per barrel, and Cenovus is projected to earn about $2.68 per share of cash flow for 2017 (assuming a conservative oil price of $53.25 per barrel for the year). This compares to $1.71 per share in 2016, and $2.07 cents in 2015.

Cenovus shares are currently pricing in extremely low oil prices for the year, which is not realistic given that oil inventories have been declining since July 2016, and the IEA states the market is currently close to balance. For the second half of the year, crude should see a deficit of at least one million bpd.

Cenovus is also being punished relative to its peers. Until recently, Cenovus traded at a premium to its peer group, and it now trades at a large discount (5.5 times 2018 EV/DACF compared to its peers at 6.8 times).

Is this discount justified?

Cenovus's huge underperformance can be linked to its recent $17.7 billion acquisition of oil sands and conventional oil assets from **ConocoPhillips**. The transaction sees Cenovus purchasing the remaining 50% interest in its oil sands assets (Cenovus shared these assets with ConocoPhillips) as well as acquiring conventional oil assets in the Deep Basin region, which will be a new growth play for Cenovus.

Investors may be curious as to why Cenovus shares sold off heavily after the acquisition, given the fact that **Canadian Natural Resources** just made a similar oil sands acquisition from a large U.S. player, and shares jumped 10%.

The poor reaction to Cenovus's acquisition occurred for two reasons: investors are concerned with the price, and investors are concerned that Cenovus is acquiring Deep Basin conventional oil assets. This is an area where Cenovus has no experience, which means the execution risk there is high. Investors also see the assets as outside Cenovus's core area of expertise.

Starting with the price, while the deal certainly was expensive, it adds value if investors assume a higher oil price going forward. Currently, the futures strip for oil prices sees oil prices under US$50 until 2020. If the market is valuing the deal using these prices, Cenovus certainly overpaid.

According to one report, using strip pricing, the assets Cenovus acquired are worth about $12.72 billion compared to the $17.7 billion Cenovus paid. However, using a more optimistic outlook ($72 per barrel average oil prices between 2018 and 2022), the assets would be worth $21.2 billion.

While this may seem optimistic, GMP First Energy predicts $75 per barrel by the end of the decade because U.S. tight oil (which is only 5% of global production) simply cannot meet growing demand, and other sources will be needed. These sources, however, have been tremendously underinvested in over the past few years.

Cenovus claims it paid $55 or $60 per barrel for the deal, which means the deal is economic at these prices.

Investors are also worried about Cenovus's balance sheet relating to the deal; the deal saw Cenovus's debt to cash flow growing from 0.7 to three in 2018. Cenovus, however, has an active plan to reduce this through selling off poorer-quality assets, and if Cenovus succeeds in its full asset-sale plan, debt to cash flow will fall to 2.7 in 2018.

A low-risk buy

Overall, the deal will see free cash flow double over time, according to **Bank of Nova Scotia**, and the market is assuming unreasonably low long-term oil prices. Cenovus will outperform in a larger oil price recovery with little downside remaining after the massive sell-off.

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