Is This Oil Sands Company Poised to Outperform?

Description

MEG Energy Corp. (TSX:MEG) has been roughly handled by the market in recent weeks, causing its stock to drop by almost 11% over the last three months even though West Texas Intermediate (WTI) gained a respectable 10%. This can be attributed to the significant discount applied to Canadian heavy crude blends against WTI and the company's weaker production. That recent weakness has created an opportunity for investors, especially given that many of fears surrounding pricing for Western Canadian Select (WCS) are overblown.

Now what?

MEG operates in the southern Athabasca region in Alberta, where it owns 2,300 square kilometres of oil sands leases and is focused on its Christina Lake SAGD project. The oil reserves across MEG's acreage were independently estimated to be just over one billion barrels. These were calculated using a WTI benchmark price of US$59 per barrel (worth $5.4 billion after taxes) and the application of a 10% discount. This comes to $18 per share, which is just over four times higher than MEG's last traded price of $4.44, thus highlighting the company's value and its considerable potential upside.

Considering the difficult operating environment witnessed since oil prices collapsed in late 2014, MEG has been able to grow production steadily during the second half of 2017. In the fourth quarter, production rose by 10% compared to a year earlier, although total 2017 bitumen output was almost 1% lower than 2016 primarily because of an outage at the Christina Lake operation due to planned maintenance completed in June 2017. MEG has forecast that 2018 production will average up to 82,000 barrels daily, which is almost 2% higher than 2017.

Impressively for an oil sands company operating in a difficult environment in which weaker oil prices and the significant discount of Canadian heavy crude to WTI is weighing on profitability, MEG is generating a respectable a netback. These are a crucial indicator of the profitability of oil producers, and MEG reported a 2017 netback of $27 per barrel, which was more than double the $13.13 recorded for 2016.

The improvement in MEG's netback can be attributed to higher bitumen prices and falling costs, which for 2017 were an impressive 12% lower than 2016. This highlights the solid profitability of MEG's Christina Lake asset, which can only grow as oil prices rise, operating costs fall, and the differential between WCS and WTI closes.

The company ended 2017 with a solid balance sheet, holding considerable liquidity with $463 million in cash and $4.6 billion in long-term debt. MEG also has a well-laddered debt profile, with no material debt repayments until 2023. This gives it plenty of time to wait for oil prices to recover and to build up its cash reserves to pay down that outstanding debt.

So what?

Despite the concerns of some pundits regarding the outlook for WCS, MEG is an appealing play on higher oil prices. The recent weakness in its price can be blamed on those concerns, which appear to be overbaked. Much of the decline in the value of WCS can be attributed to a lack of pipeline capacity and outages late last year, but the gap is being filled by crude by rail, which is causing the price differential to WTI to close. This, along with firmer overall oil prices, will give MEG's bottom-line a healthy boost, which will in turn will cause its stock to appreciate. Given how heavily discounted its price is to the after-tax value of its reserves, MEG's stock could easily double once oil prices see a sustained improvement.

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