Why This Canadian Energy Gem Will Be a Double-Up in 24-36 Months!

Description

Value investors search endlessly for value in any market. And as we're now in the 9th year of a bull market that continues to roar forward, expectations that growth firms may once again underperform their value counterparts has many long-term value investors excited.

One company which, according to my calculations, is one of the best long-term value plays at its current valuation is **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE). Cenovus is a company that I haven't shown much love for due to a number of key headwinds that remain today.

That said, I believe that within the next two to three years, Cenovus should break into the $20-$25 per share range. Here's the skinny on the factors that will likely drive such a move in the medium term.

The problem(s) with Cenovus

Among the headwinds that may drive Cenovus' share price lower in the near-term is the significant discount Canadian producers are receiving to their global peers. As I pointed out in a recent piece, the price Canadian producers are receiving for the heavy oil produced out of the oil sands (making up Cenovus' primary revenue stream) is hovering around four-year lows. This discount is likely to persist for some time given that pipelines are operating at or near full capacity, with new capacity still a ways out. Shipping Canadian crude by rail to U.S. refineries isn't an attractive option either right now given the logistical and cost-related issues associated with this mean of transport.

Additionally, new production expansion initiatives are expected to carry significantly higher breakeven values, due in part to the capital allocation that comes with such expansions. With brownfield and greenfield expansions expected to be profitable above the US$55 per barrel WTI level, betting that oil prices will rise is a very risky play given the volatility we've seen recently in the commodities sector. The more likely scenario is that Cenovus will continue to trim production levels as oil prices decline, focusing on its lowest-cost production assets and cutting costs in the very near-term to accommodate cash flow considerations.

I'm a bear on the medium- to long-term commodity price of oil, mostly because new technologies are expected to drive down the cost of production globally over the long term. Here's the opportunity I see.

Cenovus' upside

In a bid to reduce the company's breakeven price to become more competitive with other low-cost oil production technologies, Cenovus is expected to launch a new technology to extract bitumen from the oil sands known as a solvent-aided process (SAP). This technology is approximately two years away from being fully integrated into Cenovus' production process. When SAP goes live, break-even prices for the company are expected to drop substantially, potentially making the company's oil sands projects profitable at $10 or more per barrel lower than the current US$55 per barrel level currently.

If the United States continues to weaken its currency relative to other global currencies in a bid to boost trade (one of the Trump Administration's primary objectives), the Canadian dollar denominated shares of Cenovus could also see a boost. I therefore believe that a weaker CAD/USD exchange rate is likely in the medium to long term, and as such, have priced this into my model as well.

Bottom line

Cenovus is very much an example of a company with a number of serious issues, but also a number of very impressive assets that could prove to be extremely profitable in the years to come as the company works through newer, cheaper forms of production. This is therefore not an investment for the faint of heart, and a holding period of at least two to three years is warranted for any investor wanting to jump in today. That said, given the massive potential upside with Cenovus at current levels, it may be worth a shot.

Stay Foolish, my friends.

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