If This Company Doesn't Go Bankrupt, its Upside Is Parabolic

Description

Canada's oil sands are often the last place investors want to look at this point in time for value. Given the negative momentum of this sector and the expectation of continued sector declines due to pervasive headwinds, which have taken many companies lower in recent years, the risk simply appears to outweigh the potential reward for many investors at this point in time.

That being said, companies such as **Athabasca Oil Corp.** (TSX:ATH) present an extremely attractive value option for investors, given the massive discount at which the company is trading to its current asset base.

In sectors that have been pummeled by commodity prices and investor sentiment, investors have moved away from valuing companies based on production increases and top-line numbers, focusing more on the value of the assets of such companies and the productive potential of such assets in the long term.

Oil sands plays are inherently risky for a number of key reasons I have highlighted in the past. I remain bearish on this sector overall, which may make my suggestion that Athabasca may turn out to be a decent long-term play at current levels surprising. While the near-term headwinds that oil sands producers face may not abate for the next few years (at least), I believe in the long-term returns of value investing and the reality that fundamentals currently trump sentiment long term.

As such, it is important to consider with a company such as Athabasca that has clear balance sheet issues and profitability concerns what the worst-case scenario might be. I am in no way suggesting that the company is in danger of bankruptcy, although it appears a significant amount of bankruptcy risk is being priced into the company's equity currently; however, the mere fact that Athabasca's equity is trading at a 0.4 price-to-book ratio, investors have a clear margin of safety with this company. In other words, while the prices Athabasca may receive for its assets in this current environment may be artificially low due to the price of heavy oil relative to global crude prices, investors would likely receive the majority of their investment back in the event of a bankruptcy.

In the event Athabasca makes it through the next few years and continues to produce oil at a lower cost of production in the future due to new oil sands technologies, which are likely to reduce the average cost of production for firms such as Athabasca, the return for investors willing to take the short-term risk today could be massive.

Consider the fact that Athabasca has traded at a level which is approximately 15 times higher than currently in what could be considered a “normal” commodities market, absent transportation bottlenecks and an abnormally high WCS-WTI discount.

While the discount Canadian oil sands producers receive for their heavy oil remains very high, near-term issues with pipeline capacity and the lack of export options for producers has made Canadian oil unattractive globally. This trend is likely to continue, though the current discount Canadian producers receive is likely to diminish over time as supply constraints ease.

Bottom line

Athabasca is by no means an “easy” or “clean” play in this current environment; however, the valuation the market is giving this company has pushed its equity valuation down to levels that make it attractive to aggressive deep-value investors.

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Date
2025/08/01
Date Created
2018/04/02
Author

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