Heavy Oil Stocks Poised to Outperform

Description

Year to date (YTD), the TSX has stumbled, losing approximately 4% of its value. The TSX is trading at forward price-to-earnings (P/E) ratio of 15.3, down from 17.6 at the beginning of the year. The TSX is home to some of the cheapest companies on the North American stock markets. One group that is significantly undervalued is the oil and gas industry, heavy oil stocks in particular.

The biggest hurdle to the sector is oil export bottlenecks and pipeline uncertainties. These issues have caused heavy oil producers to decouple from the recent improvement in the spread between Western Canadian Select (WCS) and West Texas Intermediate (WTI). Here are three cheap stocks that should beat the market as the price of oil rises and the WCS and WTI spread narrows.

Acquisition propels growth

Cenovus Energy Inc. (TSX:CVE)(NYSE:CVE) has been under pressure ever since its $17.7 billion acquisition of **ConocoPhillips's** (NYSE:COP) oil sands operations. The company took on a great deal of debt to finance the deal and has been selling assets to reduce its leverage. Cenovus has a target net debt to earnings before interest in taxes, depreciation, and amortization (EBITDA) below two. As of end of last quarter, its debt to EBTIDA stood at 2.8, and the company is well on its way to deleverage further in 2018.

Since I last recommended the company as a buy, its share price has shot up 41%. The good news is that Cenovus still has room to run. It is still undervalued, trading at a price-to-book (P/B) ratio below one and below industry averages based on several financial metrics. The company is highly sensitive to short-term news, but, long term, it is one of the most attractive plays in the sector.

Strong cash flow

Baytex Energy Corp. (TSX:BTE)(NYSE:BTE) posted blowout earnings in early March. The market responded, and its share price jumped by approximately 14% on the back on stronger than expected cash flows. The rise in cash flows was a direct result of improving oil prices and spread between WTI and WCS. Despite the run up, it is still trading a a cheap P/B of 0.5 and an enterprise value to EBITDA of 6.10.

Although Baytex has capped its upside due to significant price hedging, it is still poised to generate significant cash flows. The company is cash flow positive at a WTI price of $55 per barrel, and its cash flow doubles for every $5 move upwards in oil prices.

Best positioned to benefit

One of my favourites in this sector is **Athabasca Oil Sands Corp.** (TSX:ATH). The company has mostly languished at the bottom of the heap following a disastrous fall from grace since its IPO in 2010. Why take a flyer on this underperformer?

The company is well positioned to take advantage of a narrowing WCS and WTI spread, as the majority of its production is unhedged. It is estimated that for every dollar increase in the per-barrel price of WCS, its cash flow jumps approximately 10%. This is tops among all heavy oil stocks. Although it is one of the riskier plays on this list, it has the potential for significant outsized returns if the export bottlenecks get resolved.

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2. NYSE:CVE (Cenovus Energy Inc.)
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