What Does Oil's Latest Pullback Mean for This Oil Sands Stock?

Description

After rebounding strongly in recent weeks and boosting optimism in North America's energy patch, crude has pulled back sharply on news that OPEC is reconsidering the ground-breaking deal on production caps, which helped to re-balance global energy markets. That is certainly worrying news for Canada's energy patch and especially for heavy oil producers such as **MEG Energy Corp.** (TSX:MEG).

You see, not only have they been sharply impacted by oil's prolonged slump, but the discount of Canadian heavy crude — known as Western Canadian Select (WCS) — to West Texas Intermediate (WTI) has widened in recent days, weighing further on their performance. Now that crude has dropped yet again and could very well fall further, oil sands stocks have been hit hard. MEG's market value has plunged by 8% over the last week, while **Athabasca Oil Corp.** has dropped by 11%. Even industry heavyweights such as **Suncor Energy Inc.** (TSX:SU)(NYSE:SU and **Canadian Natural Resources Ltd.** (TSX:CNQ)(NYSE:CNQ) are down by 4% and 6%, respectively. While there are signs that oil may fall further, now is not the time for investors to panic.

Now what?

There were indications that OPEC, or, more specifically, Saudi Arabia and Russia, was warming to the idea of boosting oil production, as substantial declines in the output of other OPEC members, notably Venezuela, have justified doing so.

Nevertheless, the likelihood of oil falling below US$50 a barrel is improbable. This is because the global economic upswing has caused demand growth to spike more than expected, helping to underpin higher prices.

Another factor helping to support the price of Canadian heavy crude is that many U.S. refineries prefer it to the lighter oil produced by the U.S. shale industry. Now that Venezuelan heavy oil production has deteriorated substantially, the demand for WCS from the U.S. can only grow. This bodes well for heavy oil producers such as MEG, which operates the low-cost, high-quality, long-life Christina Lake SAGD project.

Even if WTI falls further, MEG will remain profitable, because its breakeven costs come to US$45 per barrel, meaning that there would need to a rapid and sustained deterioration in oil prices for the company to be adversely affected. MEG has also shown itself adept at reducing operational expenses, which means that those costs should continue fall further, boosting its profitability, even if prices remain weak.

What many pundits fail to grasp is that while oil sands assets typically have higher breakeven costs than shale, they are long-life assets. This means that, unlike shale, there is little to no pressure for the operator to keep drilling to make new oil discoveries to offset natural decline rates at existing wells.

MEG is also in a solid financial position since completing $1.6 billion in asset sales during the first quarter 2018. The proceeds of those sales were used to reduce its debt by $1.2 billion, and $275 million was allocated to funding the expansion of its Christina Lake operation. MEG also has a US$1.4 billion undrawn credit facility available and no material debt repayments due until 2023, giving it considerable financial flexibility. This means that MEG is well positioned to weather weaker oil should prices fall further because of OPEC's decision to expand production.

So what?

The threat posed by OPEC's decision to alter the existing production caps and increase its oil output is very real, but it is difficult to see crude falling to the lows witnessed in 2016. After its latest pullback, MEG is an attractively valued way of gaining exposure to oil that offers considerable potential upside for investors.

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