Even After Oil’s Latest Rally, Cenovus Energy Inc. (TSX:CVE) Is an Unattractive Investment

Description

Crude continues to climb higher despite larger than expected inventory builds and Saudi Arabia’s apparent plans to grow output. The North American benchmark West Texas Intermediate (WTI) has risen by 14% since the start of 2018, while the Brent international pricing has gained 12%.

However, crude’s recent gains have done little to ease the impact of the deep discount applied to Canadian heavy crude known as Western Canadian Select (WCS). This is weighing heavily on the energy patch, where roughly half of all oil output is heavy crude and on those oil companies like **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) that are focused on producing heavy oil.

Now what?

In fact, in recent days the price differential between WCS and WTI has widened sharply ending last week at US$29 per barrel, its highest level since the start of 2018. That can be attributed to pipeline capacity constraints that are preventing oil sands producers from getting their crude to market and burgeoning inventories as oil sands companies ramp up production to take advantage of higher oil. Even increased crude by rail shipments has failed to ease the inventory overhang.

The substantial discount applied to WCS is a significant burden on Cenovus, which has seen its shares remain flat since the start of the year despite the gains by crude. This is primarily because of the impact of the widening differential between WCS and WTI on its financial performance. Even after announcing record second quarter 2018 production, which was 61% higher than the equivalent period in 2017, Cenovus reported a $418 million loss.

This was principally due to a combination of the discount applied to WCS and the ongoing slump in natural gas as well as Cenovus taking a substantial hit because of its hedging contracts. For the quarter, Cenovus’ netback was $29.06 per barrel, or 46% greater than the same quarter in 217, but after factoring in the effect of hedging and other risk management contracts, that netback fell to $12.79 per barrel.

You see, crude has rallied to prices that weren't anticipated at the end of 2017, with many industry insiders and market pundits predicting a far more modest recovery, forecasting that WTI would average around US$55 a barrel during 2018. As a result, many oil companies including Cenovus established hedging strategies aimed at reducing the impact if crude failed to rally and remained at under US$60 a barrel or slumped once again.

The weakness of natural gas, which sees the low emission fossil fuel down by 24% for the year to date, also weighed on Cenovus results. For the second quarter, the company realized a price of $1.03 per million cubic feet (mcf), which was less than half of the $2.77 received for that quarter in 2017. That had a sharp impact on Cenovus's financial performance because gas makes up roughly 20% of its production from continuing operations. It will continue to have a negative effect on the company's financial performance, as gas prices will likely remain weak for some time to come.

While demand for the fossil fuel is growing at a decent clip, there is increasing production coming online, notably in North America, which is experiencing a supply glut of natural gas. And that, along with the significant discount applied to WCS, which shows no sign of ending anytime soon, will weigh on Cenovus results for the foreseeable future.

A bright spot in Cenovus' second-quarter results was that both of its refineries achieved record utilisation rates after planned turnarounds were completed during the first quarter of 2018. The discount applied to WCS also makes those refineries more profitable to operate, as it is the heavy crude produced by Cenovus that's the primary feedstock for those operations.

So what?

While I remain bullish on energy stocks, I believe that Cenovus isn't as attractive as many of its peers. The significant discount applied to WCS and the ongoing weakness of natural gas makes Cenovus an unattractive investment. This is because of its reliance upon heavy oil and gas to drive earnings as well as the lack of any relief in sight for heavy oil or natural gas prices.

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