Is This Oil Sands Stock the Best Way to Play Higher Oil?

Description

Oil has rallied once again to see West Texas Intermediate (WTI) break through the psychologically important US$70 a barrel mark to climb to around 21% year to date. This has been a boon for Canada's beaten down energy patch, sparking a sustained rally among energy stocks including **MEG Energy Corp.** (TSX:MEG), which has soared by 63%, thereby significantly outstripping oil's latest gains. There are signs that MEG will appreciate further, especially as oil climbs higher because of emerging supply constraints and better than expected demand growth.

Now what?

MEG's flagship asset is the multi-phased Christina Lake steam-assisted gravity drainage (SAGD) project. This, along with the Surmont SAGD project, gives it net oil reserves of almost 2.2 billion barrels, which have an after tax net asset value of $50 per share. That is almost six times greater than MEG's current market price, indicating the tremendous potential upside.

The value of the company's oil reserves will expand because of higher oil prices, as their value was calculated using an estimated average price for WTI of US$59 a barrel for 2018 and 2019. WTI is trading well above that amount and has averaged around US$65 per barrel since the start of the year.

MEG's Christina Lake operation is an attractive asset, as like the majority of SAGD bitumen facilities, it is a long-life, low-cost asset requiring a conservative level of sustaining capital to maintain production. That means it has relatively low breakeven costs.

According to the Canadian Energy Research Institute SAGD, operations have average breakeven costs of around US$43 per barrel, which is almost 30% lower than what they were 2015. In the case of MEG, analysts estimate that its company-wide break even cost is US$45 a barrel, highlighting the profitability of the crude it produces particularly now that WTI is at over US$70 per barrel.

MEG is also focused on reducing its cash costs by $3 per barrel produced, which, along with higher crude, will give margins and its bottom line a healthy boost.

The company reported solid first quarter 2018 results, including a 21% year over year increase in bitumen production and a remarkable 29% decrease in net operating costs. Such solid results should continue over the course of 2018.

Firmer oil prices coupled with MEG's stronger balance sheet will allow the bitumen producer to further boost spending on Christina Lake, which will give production a solid lift as each stage of the project is completed. Already in February 2018, after completing asset sales worth $1.6 billion, MEG boosted its capital spending by $190 million to $700 million, which will be used to fund the Christina Lake phase 2B brownfield expansion.

Full-year 2018 production is expected to average at least 85,000 barrels daily, which is a 5% increase over 2017. That along with lower operating costs and higher crude, will give MEG's earnings a healthy lift.

So what?

Oil sands producers may not be the most popular investment, primarily because of higher operating costs and the deep-discount applied to Canadian heavy oil. However, MEG is shaping up to be one of the best ways to play higher because of the low costs associated with its Christina Lake operations, growing production, commitment to reducing expenses and stronger balance sheet. It isn't difficult to see the company's stock soaring as oil climbs higher because of emerging supply constraints and greater demand.

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mattdsmith