



1 Oil Sands Company That's Ready to Soar

Description

Oil has shaken off bearish news to rally once again to see the North American benchmark West Texas Intermediate (WTI) trading at close to US\$70 a barrel at the time of writing, representing a gain of almost 20% year to date.

This has acted as a powerful tailwind for beaten-down oil stocks, with some, such as **MEG Energy Corp.** ([TSX:MEG](#)) significantly outperforming oil. The oil sands producer has rallied by 32% since the start of 2018 and there are signs of further gains ahead.

Now what?

A key risk facing heavy oil producers such as MEG is that while WTI continues to move higher, the [differential between](#) Canadian heavy oil known as Western Canadian Select (WCS) and WTI has widened considerably. This sees WCS trading at US\$39.46 a barrel, which represents a 42% discount to WTI and is almost as great as its peak in February 2018, when the discount reached 46%.

The sharp discount applied to WCS is impacting the profitability of MEG and other oil sands companies, which becomes evident when considering their operating netback – a key measure of profitability – reported by oil sands companies.

For the second quarter 2018, MEG reported an operating netback of \$18.53 per barrel produced compared to \$22.96 a year earlier despite the average price for WTI over the quarter being 41% higher. This is also considerably lower than the \$31.75 per barrel reported by light oil producer **Whitecap Resources Inc.**

This can be attributed to a combination of the discount applied to WCS and MEG incurring a substantial loss on its commodity price risk management contracts.

You see, many analysts and industry insiders at the end of 2017 were not expecting crude to rally significantly, which saw many upstream oil companies including MEG implement a range of hedges aimed at mitigating the impact of weaker oil.

Those hedges for the second quarter caused MEG to incur a cost of \$89 million, which comes to a loss of \$13.11 per barrel, and this was almost nine times greater than it had been for the same period in 2017.

Nonetheless, a large proportion of those hedges will unwind at the end of 2018 meaning that if higher oil remains in play, MEG's profitability and earnings in 2019 will receive a solid boost.

A pleasing aspect of MEG's first half 2018 performance is that production was greater than expected, causing it to revise its full-year guidance higher to see MEG expecting production to average up to 90,000 barrels daily.

This appears to be achievable given that MEG's Christina Lake operation in July produced on average 98,000 barrels per day, meaning that it can more than adequately make up for the second quarter production decline caused by maintenance activities.

It is feasible to expect MEG's oil output to grow further in 2019 as it invests further capital to develop Christina Lake to its forecasting production of 113,000 barrels daily by 2020. That, along with the hedges covering a large portion of MEG's oil production unwinding and higher oil, will give its earnings a solid lift.

So what?

MEG is an attractive play on the optimistic outlook for oil, and its earnings will grow at a solid clip as [crude rises further](#), its hedges unwind, and production expands. This should give MEG's market value a healthy boost, meaning that even after gaining 32% year to date, there is further upside ahead.

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Date

2025/08/23

Date Created

2018/09/17

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