Is Athabasca Oil Corp. (TSX:ATH) the Next Takeover Target?

Description

Husky Energy's recent takeover offer for oil sands producer **MEG Energy** at a premium of 37% over the pre-offer market price has brought the spotlight back on Canada's energy patch and sparked speculation that another round of consolidation may have begun. One company that could be the next takeover target is intermediate oil producer **Athabasca Oil** (TSX:ATH). Like MEG, Athabasca battled to survive the protracted slump in crude, which began in late 2014, because it had loaded up on debt, and its operations were predicated on the concept of US$100-a-barrel oil.

Nonetheless, Athabasca has managed to pull through the oil slump in reasonable shape, and crude's latest rally, which sees the North American benchmark West Texas Intermediate (WTI) trading at above US$75 a barrel, makes it an attractive investment.

Now what?

A significant issue that has been weighing on Athabasca's financial performance is the substantial discount applied to Western Canadian Select (WCS), which is the benchmark price for bitumen and other forms of heavy oil produced in Canada. Since the end of May 2018, the prices of WCS and WTI have diverged sharply to see WCS trading at over US$30 a barrel less. This is having a sharp impact on the financial performance of Canada's oil sands operators. In the case of Athabasca, its thermal oil operations reported a second-quarter 2018 operating netback of $15.79 per barrel produced compared to $28.64 for its light oil division.

There is every sign that discount will continue for the remainder of 2018 and into 2019, because of pipeline bottlenecks and other transportation constraints. This will continue to negatively affect Athabasca, because 68% of its oil production is weighted to bitumen.

What makes Athabasca an attractive takeover target is its considerable oil reserves, totaling 982million net barrels, which, after tax and deducting long-term debt, have a net asset value (NAV) of$4.64 per share. This is almost three times greater than its market value, highlighting the considerablepotential upside available and why Athabasca is an attractive acquisition target. The value of thosereserves will expand significantly in the current operating environment.

You see, the NAV was calculated using an assumed average 2018 price for WTI of US$58.50 per barrel and US$58.70 for 2019. Both of these forecasts are lower than the current spot price of US$75 a barrel and the average price for WTI since the start of 2018, which is US$66 per barrel.

Athabasca is also steadily growing its oil production, reporting a second-quarter increase of 3% year over year to 37,658 barrels daily and forecasting a 10% compound annual growth rate between 2018 and 2020. That oil output was 84% weighted to crude and other petroleum liquids, meaning that weaker natural gas prices have little impact on Athabasca's financial performance. These solid results indicate that Athabasca is on track to achieve its 2018 production guidance of 39,000-41,000 barrels daily with an 87% weighting to oil and natural gas liquids.

Importantly, at the end of September 2018, hedges on 33,000 barrels daily of oil production unwound, and the remaining risk-management contracts for 7,000 barrels daily will end in December 2018. This means Athabasca is positioned to fully benefit from higher oil and the increasingly optimistic outlook for crude.

The company is holding long-term debt of $554 million, which is a worrying five times operating cash flow, increasing Athabasca's vulnerability to weaker oil and reducing its financial flexibility. This has ratcheted up the degree of risk associated with investing in the company and has been weighing heavily on its market value.

So what?

Athabasca is an attractive but somewhat risky play on higher oil. While it has rallied by almost 50% since the start of 2018, which is well ahead of WTI's 31%, there is further considerable upside ahead, as highlighted by the value of Athabasca's oil reserves and its growing production. These factors make it an attractive target for any energy major seeking to expand its presence in Canada's energy patch and, notably, the oil sands.

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