Cenovus Energy Inc. (TSX:CVE) Will Struggle to Unlock Value Despite Higher Oil

Description

Like many Canadian energy stocks, oil sands producer **Cenovus Energy** (TSX:CVE)(NYSE:CVE) has failed to keep pace with the rally in crude. While the North American benchmark West Texas Intermediate (WTI) has gained a whopping 31% since the start of 2018, Cenovus has only appreciated by 8%. There are a wide range of reasons for this, including fears that crude will pull back sharply before the end of the year with some pundits predicting that WTI could fall to well under US$70 a barrel.

Now what?

A key issue substantially impacting Cenovus is the significant discount applied to Canadian heavy oil. The prices of Western Canadian Select (WCS) and WTI have diverged sharply in recent months to see WCS trading at a 44% discount to the North American benchmark at the end of September.

This is having a considerable negative effect on Cenovus's profitability and earnings. For the second quarter 2018, the company reported an operating netback, which is a key measure of an oil producer's profitability, of $29.06 per barrel, which was far lower than many of its smaller peers that produce predominantly light oil. The poor netback was caused by the deep discount applied to WCS, which makes up 75% of Cenovus's petroleum output.

You see, the company only realized an average price of around US$36 per barrel of crude sold compared to WTI's average of US$65.37 a barrel for the quarter, because of the widening spread between WCS and WTI. There is no sign of that discount easing anytime soon because of pipeline bottlenecks and other transportation capacity constraints, which are causing heavy oil inventories in Alberta to reach record levels.

Another problem is that 18% of Cenovus's production is made up of natural gas. Weak natural gas prices and hence low margins for that production are also weighing on its financial performance.

In fact, despite recent gains, natural gas appears poised to enter another protracted slump, because growing demand for the fuel doesn't appear capable of significantly buoying prices for a prolonged period because of a notable increase in supply. Cenovus's natural gas production, which is predominantly extracted from its Deep Basin acreage, only generated an operating netback before hedging of $6.94 per barrel of oil equivalent produced.

Those netbacks were adversely affected by the risk-management contracts that Cenovus has established to mitigate the possibility of lower oil prices. The loss incurred on those hedges dragged Cenovus's company-wide netback down to an unimpressive $12.79 per barrel. Even when those hedges unwind, the majority of which will occur at the end of 2018, it won't be enough to give the company's earnings a solid lift, unless the significant price differential between WCS and WTI narrows considerably.

Cenovus is also carrying a substantial amount of long-term debt totaling almost $10 billion, which is a worrying six times operating cash flow, indicating that it is susceptible to weaker oil if prices collapse once again. The tremendous financing costs associated with such a huge pile of debt also make Cenovus vulnerable to higher interest rates in an operating environment where rates are rising. This will cause the cost of capital to rise, increasing interest expenses and making it more difficult as well as costly for Cenovus to raise additional capital if required.

So what?

It is not hard to see Cenovus's earnings growing at a reasonable clip for as long as the price of WTI remains firm and when most of its hedges unwind at the end of 2018. This should give its share price a much-needed boost.

Nonetheless, weak natural gas prices and the considerable discount applied to WCS will weigh on its financial performance for the foreseeable future. For these reasons, many of its peers with superior quality, more diversified operations, and a greater proportion of higher-margin light-oil production will unlock superior value for investors.

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Date
2025/07/29
Date Created
2018/10/04
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