Get Ready for This Latin American Natural Gas Driller to Soar

Description

Despite the poor outlook for natural gas, some drillers are uniquely positioned to benefit from specific local market inefficiencies. One such energy company is **Canacol Energy Ltd.** (TSX:CNE), which operates in the Latin American nation of Colombia. Since the start of 2018, Canacol has lost almost 14% and failed to rally despite the recent spike in natural gas prices that sees the fuel up by roughly 10% over the last month.

Now what?

The decline in Canacol's stock can be attributed to a variety of factors including the driller's move to divest itself of its conventional oil assets in an environment where crude is rallying**,** and its considerable focus on becoming a Colombia centered natural gas producer. It is this last point that has also weighed on its stock price because of recent security incidents in Colombia, where dissident groups have attacked mining and oil company employees and assets.

The market's negative perception of Canacol appears overbaked, particularly given that the company reported some impressive second quarter 2018 results. These included a remarkable 25% year over year increase in production and sales volumes for the quarter.

While Canacol's operating netback – a key measure of operational profitability – fell by 2% compared to a year earlier, it was still a credible US$22.90 per barrel of oil equivalent produced. The primary reason for its decline compared to a year earlier**,** and despite higher oil**,** is that during the first quarter 2018 Canacol completed the sale of its tariff oil assets located in Ecuador as part of its initiative to become a leading Colombian natural gas producer.

Canacol is continuing to implement that strategy, having recently sold its conventional oil assets in Colombia to Arrow Exploration Ltd. This saw it divest six producing oilfields holding reserves of 8.6 million barrels and producing 1,375 barrels per day.

Canacol received proceeds from the sale of US$40 million composed of US$15 million in cash, US$5 million in promissory notes from Arrow and US$20 million of Arrow stock. The company plans as a return of capital to distribute the Arrow stock to shareholders as special dividend.

The deal will save Canacol US$66 million in exploration and transportation commitments as well as reduce general and administrative costs by up to 20%. That deal also bolstered its balance sheet, adding an additional US$15 million to existing cash at the end of the second quarter totalling US$55 million.

Canacol is experiencing considerable exploration success in Colombia. It recently reported a drilling success rate of 80% and between 2013 and 2017, tripled its oil and gas reserves through a combination of exploration, well development and acquisitions. By the end of 2018 Canacol expects to add another 10 million barrels of oil equivalent to its reserves.

What makes Canacol such a compelling play on natural gas aside from its quality assets and growing production are the local dynamics of Colombia’s natural gas market. After decades of being self-sufficient for its natural gas, Colombia is experiencing a shortage of gas, which forced it to commence bulk LPG imports in 2017.

Those shortages are growing because of declining production from existing aging gas fields, the lack of large gas discoveries in recent years, and growing residential as well as industrial demand. Therefore, the Colombian government has implemented policies aimed at promoting natural gas exploration and production as well as attracting further investment from foreign oil companies.

Because of these unique local circumstances, Canacol has contractually locked in a well head price of US$4.85 per thousand cubic feet (mcf) of natural gas sold, which is over 25% greater than the U.S. market price. That sees the company reporting a solid operating margin of greater than 75%, higher than many of its North American competitors.

So what?

It is difficult to understand why the market has treated Canacol so harshly. The driller possesses solid reserves, quality assets and is well-positioned to benefit from natural gas supply shortages in Colombia. For these reasons the latest sell-off of its stock appears overdone and has created an opportunity for contrarian risk tolerant investors.

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