



Higher Bitumen Prices Will Benefit This Oil Sands Producer

Description

In a surprise move after lobbying by some of the largest oil sands producers, notably **Cenovus Energy Inc.** and **Canadian Natural Resources Ltd.**, the government of Alberta elected to introduce mandatory production cuts. This has had an immensely positive effect on the price of Canadian heavy crude known as Western Canadian Select (WCS). Since the cuts were announced, WCS has more than doubled in price from its record low of under US\$12 per barrel to be trading at over US\$31 a barrel at writing. This will be a boon for Canadian oil sands producers such as **MEG Energy Corp.** ([TSX:MEG](#)), which were labouring under the weight of weaker crude and the deep-discount applied to WCS.

Now what?

The move by Alberta to implement mandatory production cuts comes on the back of oil inventories in the province surging to record highs because of transportation bottlenecks and growing oil output. Those constraints are the result of a lack of pipeline capacity to move the crude produced in Western Canada to crucial U.S. refining markets. There is no sign that those bottlenecks will ease anytime soon. Even record crude by rail shipments has failed to reduce the localised oil glut, and the construction of additional pipeline capacity can take years because of regulatory hurdles, capital demands and the lengthy construction time.

While the North American benchmark West Texas Intermediate (WTI) has fallen sharply since hitting a multi-year high in early October 2018, to be down by around 18% for the year to date, many oil sands stocks have surged. This is because of Alberta's production cuts. MEG is still up by 49% over the same period, and there is every sign that if the differential between WCS and WTI doesn't widen sharply, the company will make further gains when oil recovers after the latest OPEC [production cuts](#) are introduced in January 2019.

A key reason for MEG's price remaining firm despite oil's latest collapse is the [takeover offer](#) by **Husky Energy Inc.**, which has offered to acquire MEG shares for \$11 each, representing a premium of 40% over its market price. The oil sands producer also reported a solid third quarter 2018, which also helped to buoy its market value.

Bitumen production shot up by 19% year over year to 98,751 barrels daily. While MEG's netback – a key measure of operational profitability – fell by 11% compared to a year earlier primarily because of the deep-discount applied to WCS, net earnings rose by 40% to \$118 million. Despite WTI weakening significantly since early October, MEG's earnings should remain firm because of the substantially narrower differential between WCS and WTI.

For these reasons, it appears that MEG can achieve its revised 2018 guidance issued in August, where it anticipates annual average production of up to 90,000 barrels of bitumen daily.

MEG finished the third quarter with total debt of a whopping \$3.6 billion, a very worrying nine-times the company's trailing 12-months funds flow from operations. That does make MEG quite vulnerable amid a difficult business environment where crude remains weak. It should be noted, however, that the company finished that period with almost \$373 million in cash, which does help to reduce the risks associated with having such a large pile of debt.

So what?

In the current harsh operating environment, MEG is a difficult company to like. While higher WCS prices because of Alberta's planned production cuts and MEG's commodity hedges will ease the impact of weaker oil, the overall outlook is not as bright as it was in early October.

Nonetheless, the combination of firmer bitumen prices for the foreseeable future, and Husky's takeover offer will put a floor under MEG's share price. If oil rallies as anticipated when the OPEC production cuts come into effect, then its stock will rally.

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