Is it Time for Athabasca Oil Corp. (TSX:ATH) to Soar?

Description

Oil has rallied sharply after plunging sharply at the end of 2018 to see the North American benchmark West Texas Intermediate (WTI) trading at over US$50 a barrel. The belief among analysts is that the late-December 2018 sell-off of crude went too far, and that means there is plenty of room for oil to rally further. This is good news for Canada's energy patch, where many producers, including **Athabasca Oil** (TSX:ATH), have been weighed down by a combination of weak oil, wide differentials between Canadian crude blends and WTI, and high operating costs. Despite the latest rally, Athabasca stock is still down by 15% over the last year, triggering speculation that there is more upside ahead for the company, especially if WTI firms further.

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Alberta's production cuts will boost earnings

Even though WTI has recovered to US$50 a barrel, many pundits have failed to consider the positive effect of Alberta's mandatory production cuts on prices for Canadian crude blends. Canadian light oil is trading at around a US$3 per barrel discount to WTI, while heavy oil known as Western Canadian Select (WCS) has a discount of roughly US$10 per barrel.

Those discounts are at their lowest levels for some time and will go a long way to boosting earnings for Canadian oil stocks, particularly heavy oil producers, despite WTI pulling back to mid-2017 prices. This is important for Athabasca because 75% of its production is comprised of bitumen produced by its Hangingstone and Leismer thermal oil operations.

Athabasca is forecasting that for 2019 it will produce around 40,000 barrels daily, which roughly the same as the 38,500-41,000 barrels expected for 2018.

A key problem with heavy oil operations is the cost of all-important diluent, which is required to make bitumen flow so that it can transported. That expense will rise further as WTI appreciates and oil sands production starts to grow once Alberta's production cuts wind down towards the end of 2019.

This adds to the already high operating expenses associated with oil sands, which means they have higher breakeven costs than conventional and shale oil production. The breakeven cost for

Athabasca’s Hangingstone operation, which is responsible for 28% of its petroleum output, is US$53 per barrel WTI, indicating that based on current prices, it is making a loss on every barrel of bitumen that it produces.

While Athabasca’s third-quarter 2018 production grew at a solid clip, rising by 12% year over year, it is unlikely to continue reporting growing oil output because it has elected to slow its thermal oil production because of weaker oil. The deep discount that was impacting WCS until production cuts were announced continues to weigh on Canadian natural gas prices. This is because the root cause is essentially the same — a lack of transportation capacity preventing the gas produced from reaching key markets.

The Canadian AECO natural gas price currently trades at a discount of US$1.78 per million British thermal units (MBTU) to the Henry Hub spot price, and this is having a sharp impact on the performance of domestic natural gas producers. In the case of Athabasca, the negative effect of this wide price differential isn’t of any significant concern, because only around 12% of its production is weighted to natural gas.

Because there is every sign that WTI will rally further, potentially to as high as US$60 per barrel, Athabasca’s earnings will grow at a healthy clip, especially because of the substantially narrower differential for WCS against WTI. Athabasca has also established a hedging program aimed at reducing the impact of sharply weaker oil.

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Because of the volatile and uncertain outlook for crude, Athabasca has cut its 2019 capital spending by around 50% compared to 2018. Both funds flow from operations and its bottom line should grow, especially when the narrower differential for WCS is accounted for.

Stronger balance sheet

The company has also bolstered its balance sheet, recently completing the $265 million sale of its Leismer pipeline and storage infrastructure to midstream services giant **Enbridge**. That boosted Athabasca’s liquidity to $525 million, giving it the ability to weather any further downturns in crude while continuing to fund the development of its thermal oil assets.

Is it time to buy Athabasca?

For these reasons, Athabasca’s stock should rally higher as the price of crude rises. Because it is a highly levered play on crude because of its considerable long-term debt totalling $547 million, its price will soar if WTI continues to appreciate.

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