

Is it Time to Buy Encana Corp. (TSX:ECA)?

Description

Canada's third-largest natural gas producer **Encana** (TSX:ECA)(NYSE:ECA) has been heavily marked down by the market, losing 49% over the last year. This can be attributed to the poor outlook for natural gas and Canada's gas crisis; the local AECO benchmark continues to trade at a steep discount to the Henry Hub spot price. While natural gas prices spiked in late 2018 because of unseasonably cold weather, they have pulled back sharply in recent weeks, further weighing on Encana's outlook.

Nonetheless, the upstream energy producer has been making steady progress to reduce expenses and its dependence on natural gas, which the market is failing to recognize. This means that the sharp decline in Encana's value has created an opportunity for investors to acquire a quality upstream oil and gas producer at an attractive valuation.

Improved operational results

The driller has been growing its oil and other liquids production at a steady clip. For the third quarter 2018, oil production expanded by 27% year over year to 95,500 barrels, while high value condensate output shot up by 47% to 47,000 barrels daily. That saw oil and condensate make up 36% of Encana's total hydrocarbon output, while natural gas made up the remaining 64%.

The move to a more balanced production profile will continue because of Encana's acquisition of Newfield Exploration, which is expected to be completed during the first quarter of 2019. That US\$5.5 billion needle-moving deal will add Newfield's liquids-rich acreage in the Andarko, Williston and Uinta basins to Encana's existing assets. This will add an additional over 200,000 barrels of daily production, which is almost 40% weighted to oil to Encana's total petroleum output.

Because most of Newfield's acreage is in the U.S., the [discounts](#) applied to Canadian oil blends and natural gas won't apply, meaning that Encana will receive a higher realized price for that production. This — along with greater crude and natural gas output — will boost Encana's earnings.

The combined business will focus on three core assets. First is the prolific Permian basin, where it owns 118,000 acres, producing 99,000 barrels daily, which are 85% weighted to crude. Then there is the 360,000 acres it owns in the STACK/SCOOP play in the Andarko basin, producing 144,000 barrels daily, which are 60% comprised of oil. Finally, it has 379,000 acres in the booming Montney formation, which is producing 201,000 barrels oil daily that is 21% weighted to oil.

Those are all quality assets, and it appears that the market fails to appreciate the combined entity's strengths, including its high netback oil and gas acreage. On completion of the deal, the combined company will become a leading North American upstream oil explorer and producer. While the combined entity's debt of US\$6.7 billion does appear alarming, it is estimated to come to a very manageable 1.5 times adjusted EBITDA. Encana also recently completed the US\$480 million sale of its San Juan assets in New Mexico, which will further bolster its balance sheet and provide it with

additional liquidity.

Encana expects to complete a US\$1.25 billion share buyback once the transaction is complete, which will buoy the combined company's market value and hike the dividend by 25%. The combined entities market value will be further supported by higher oil with WTI expected to rally further over the course of 2019, with some analysts predicting it could rise to over US\$60 a barrel, because of [OPEC production cuts](#).

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Encana hasn't been among my preferred energy companies for gaining exposure to oil for some time, but the latest transaction certainly enhances its appeal, particularly because it bolsters its U.S. landholdings and production. That will boost profitability and earnings, which — along with the improved outlook for crude and Encana's planned stock buyback as well as the 25% dividend increase — should give its stock a healthy lift.

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