



What Is the Outlook for MEG Energy Corp. (TSX:MEG)?

Description

Husky Energy Inc.'s unsolicited offer to acquire the oil sands producer **MEG Energy Corp.** ([TSX:MEG](#)) expired last week and the energy major stated it would not extend the offer because of growing uncertainty over the outlook for crude. After the offer expired, MEG's stock plunged sharply, seeing it down by 12% over the last year and leading to speculation that now is the time to buy the bitumen producer. While MEG's management rejected the offer because it believed that it did not recognize the company's full value or long-term potential, the current uncertain operating environment indicates there maybe rocky times ahead for the company.

Higher Canadian oil prices

Moves by the Alberta government to prop up the price of Canadian heavy crude have thus far been quite successful. After the provincial government announced mandatory production cuts of 325,000 barrels per day Canadian heavy and light oil benchmark prices Western Canadian Select (WCS) and Edmonton Par surged to more than double their record 2018 lows.

Those prices were further backstopped by Edmonton's announcement that it was considering long-term [solutions](#) to the primary cause of weaker Canadian oil prices — the lack of pipeline exit capacity. These include boosting refinery capacity in Western Canada and ramping up crude by rail by pushing Ottawa for further investment in rail infrastructure and proposing that it would purchase tanker cars.

In recent weeks, the price differential between WCS and the North American benchmark West Texas Intermediate (WTI) has narrowed to US\$10 a barrel. This means that Canadian heavy oil is selling for US\$42.62 per barrel, which is more than three-times greater than its November 2018 record low. This bodes [particularly well](#) for those oil sands operators like MEG who have no refining capacity, which makes them solely dependent upon shipping the bitumen they produce to U.S. refining markets to generate revenue.

Surprisingly, this makes MEG's operations significantly more profitable despite WTI trading at US\$52.62 a barrel, which is 6% lower than it was in November 2018 when WCS fell to its record low.

Quality assets

Key to MEG's future is its flagship Christina Lake SAGD project, which reported record quarterly production of 98,751 barrels daily for the third quarter 2018. This represented a 19% increase compared to the equivalent period a year earlier and underscores the tremendous potential held by Christina Lake, explaining why Husky was willing to pay a notable premium to acquire MEG. That substantial production growth meant that MEG was on track to achieve the upper end of its 2018 guidance, where it projected average annual output of 87,000 to 90,000 barrels daily.

For 2019, MEG anticipates that production will grow further, forecasting average daily oil output over the year of 90,000 to 92,000 barrels daily which at the top end represents a 2% increase year over year. By 2020, that is projected to total 100,000 barrels daily and more than double to 210,000 barrels daily by 2028.

Astonishingly, MEG expects to achieve this production growth despite its 2019 capital budget being less than half of the \$510 million initially budgeted for 2018, thereby indicating that much of the investment required to expand operations at Christina Lake has been completed. Such strong production growth positions MEG to not only benefit from the markedly reduced discount applied to WCS but also from the improving outlook for crude with analyst predicting that WTI could rally to as high as US\$65 per barrel.

Because of its low operating costs, which, after including general and administrative costs, MEG estimates are around \$8.54 per barrel produced, the Christina Lake asset is highly profitable even with WTI trading at around US\$50 per barrel. In fact, in late 2017 analysts estimated that MEG's operations broke even with WTI at US\$45 a barrel. Those costs are likely closer to US\$40 a barrel because of operational improvements made over the last year and a half.

It is this formidable production growth coupled with low industry leading cost structure that illustrates why Husky sort to acquire MEG and its management rejected the offer on the basis that it didn't recognise the company's true potential.

Is it time to buy MEG?

While Alberta's production cuts won't continue forever, with them expected to wind down in late 2019 when Enbridge's line 3 expansion is commissioned, it is clear that MEG holds considerable potential and that its earnings will grow at a solid clip. Because it is highly levered to the price of crude, the oil sands operator provides investors with the ideal investment to bet on oil recovering during 2019.

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