



Is Encana Corp (TSX:ECA) Running Out of Growth Opportunities?

Description

In 2014, **Encana** (TSX:ECA)(NYSE:ECA) purchased Freeport-McMoRan's Eagle Ford assets for \$3.1 billion. While the deal was executed at a healthy market premium, management believed they could integrate the assets into their portfolio, driving new synergies to get more value from the assets than the previous owner.

Shortly after the deal consummated, oil prices fell by more than 50%, eliminating any benefit from efficiency improvements. Quite frankly, Encana overpaid. A few short years later, investors also became concerned that the acquisition's once-impressive cash flows were drying up.

For the first three quarters of 2018, Encana's Eagle Ford production fell to 44,400 barrels of oil per day from 47,700 barrels of oil per day in 2017. Encana's Eagle Ford production was also higher over the same period in 2016, meaning the company is likely facing a structural decline in volumes there. Even when oil prices zoomed past \$60 per barrel, the company wasn't able to eke out excess production, demonstrating even more evidence that its best days are over in the Eagle Ford region.

Clearly, the company's \$3.1 billion Eagle Ford acquisition was an objective failure. Even if the company made the most out of the deal, buying at the top of a bull market is always difficult to overcome. Looking ahead, can Encana still find growth in its other assets?

Management remains overly optimistic

At current energy prices, Encana's management team anticipates generating \$500 million in free cash flow in 2019. Cumulatively, from 2018 through 2022, it expects to generate \$3 billion in free cash flow. With a market cap of just \$9 billion, that would be an impressive feat.

Much of this cash flow is a result of management's multi-year efforts to improve its profitability at low oil prices. In 2016, cash margins per barrel of oil were just \$6.49. In 2018, those margins rose to more than \$16 per barrel, an increase over management's original forecast of \$14 per barrel. By shifting its production mix and finding new efficiencies, Encana seems to have set the company up for success.

What is Encana doing with this excess cash? In 2018, the company repurchased more than \$250 million in stock. Management is also looking to merge with **Newfield Exploration** (NYSE:NFX) to offset its growing hurdles in the Eagle Ford region. Newfield's crown assets include its STACK/SCOOP fields in Oklahoma, but the deal also includes assets in the Arkoma and Williston basins.

The Federal Reserve Bank of Dallas estimates that these assets can be profitable at oil prices of US\$53 or more. That may be a difficult hurdle to jump considering current prices are around the same level. So, either Encana needs oil prices to jump to justify the deal, or it needs to find savings elsewhere.

One of the biggest levers to pull is to reduce headcount. Encana's management thinks it can remove \$125 million in costs from Newfield's business by reducing costs like headcount. The company said it has "high confidence" in achieving these synergies, but it said the same thing about its acquisition of Freeport-McMoRan's Eagle Ford assets. If oil prices don't cooperate, it doesn't matter how many synergies are attained.

Encana is a bet on only one thing

Encana's management team has done a terrific job improving the company's assets over the last few years, but poor timing has erased any potential gains from those actions. Over the past five years, Encana stock has lost more than 50%.

Today, only higher prices will help the company. Its core, low-cost regions are reaching full maturity, and its newly acquired assets have higher breakevens and a lower quality production mix. A bet on Encana today is simply a bet on higher oil prices.

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