Don’t Buy Cenovus Energy Inc (TSX:CVE) for 1 Reason

Description

Despite its falling share price, **Cenovus Energy** (TSX:CVE)(NYSE:CVE) is one of the better-positioned oil companies today. It has $6.4 billion in liquidity versus a $12.5 billion market cap, 42 years left of reserves, and a large refining arm that can offset volatility in commodity prices.

Yet this year, shares are close to their lowest prices in history. With the oil market out of favour, should you pick up Cenovus Energy stock at today’s beaten-down valuation?

Oversupply is killing Cenovus

Due to its positioning in Alberta, Cenovus has been hit hard by structural limitations with pipeline and terminal capacity.

As I wrote in January, “Not only must oil sands producers pay more to refine and ship their output, but they’ve been forced to sell at a discount in recent months.” *The Globe and Mail* was even more pessimistic, reporting that “Canadian crude has become the most discounted oil on the planet.”

The reason for the discount should have been predictable because its occurrence was largely unavoidable.

In 2018, companies in Alberta produced roughly 10-15% more oil than the existing pipeline capacity could handle. The result was a price war. Without enough terminals to store their output, producers were forced to bid more aggressively than ever. At one point, Albertan crude prices were trading at a discount of more than 50% to U.S. prices.

On December 2, the Alberta government imposed a temporary industry-wide production cut of 325,000 barrels per day. The goal was to quickly reduce the oil glut and re-establish pricing parity with the U.S.

While the discount has narrowed immensely, the past six months of depressed selling prices crippled Cenovus. For every $5 difference between Canadian and U.S. oil prices, Cenovus would either add or subtract $500 million in free funds flow. Closing the gap completely should be its highest priority, but it’s limited in what it can do unilaterally.

Two shifts need to happen this year

Cenovus has a bright future if two things happen. First, it needs to reduce its exposure to Canadian oil prices. Second, more pipeline infrastructure needs to come online.

For 2019, the company has the infrastructure in place to mitigate up to 60% of its Canadian pricing exposure. Its refinery businesses play a big role in this, as they allow for the processing of lower-quality output into oil capable of fetching U.S. prices.

Cenovus has also established crude-by-rail deals with **Canadian National Railway** and **Canadian Pacific Railway** to bypass pipelines altogether.

Finally, new salt cavern storage capacity at Foster Creek and Bruderheim gives the company more flexibility to handle any future pricing collapses.

In total, Cenovus is doing all it can to reduce its exposure to widening price differentials, but there’s still one major shift that needs to happen: more pipelines need to enter the market.

By the second half of 2019, **Enbridge’s** Line 3 replacement will provide 375,000 barrels per day of new pipeline capacity. If it weren’t for rising oil production in the region, this would soak up nearly all the current excess. Unfortunately, oil companies are expected to continuing growing output, meaning even more pipelines will be needed to correct the market imbalance.

By 2020 or 2021, the Keystone XL and TMX pipelines are expected to enter service. If this were to happen, there would be enough pipeline capacity for the entire region until possibly 2030. While it’s outside Cenovus’s control, this needs to transpire for shareholders to succeed.

You’re betting on pipelines, not Cenovus

Cenovus is doing all it can to manage the current crisis, but its future is out of its hands. If the Keystone XL and TMX pipelines don’t enter service next year, things could turn from bad to worse.

If you buy Cenovus shares today, you’re simply rolling the dice.

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Author
rvanzo