Ignore the Poor Outlook for Natural Gas and Buy This South American Driller

Description

A prolonged slump in natural gas prices, which sees the North American Henry Hub benchmark trading around US$2.62 per million British thermal units (MMBTU), coupled with the deep discount applied to Canadian AECO gas pricing is making many domestic natural gas drillers unattractive investments. Those factors shouldn't deter investors from making contrarian investments in natural gas producers with solid balance sheets, quality assets, and the ability to access premium pricing outside Canada. One such company is **Canacol Energy** (TSX:CNE), which has gained 5% since the start of 2019, and there are signs of further upside ahead.

Quality assets and growing production

Canacol has become a leading natural gas producer in the South American nation of Colombia where it has almost 1.2 million net acres comprised of eight blocks in the Llanos, Middle Magdalena, and Lower Magdalena basins. At the end of July 2018 and after divesting the majority of its Colombian oil assets in late September 2018, Canacol had reserves of 113 barrels of oil equivalent, which was 88% weighted to natural gas.

By the third quarter 2018, Canacol had grown its production to an average of almost 22,000 barrels of oil equivalent daily, which was 33% greater than for the equivalent period in 2017 and 92% weighted to natural gas. The driller expects its oil equivalent production to reach over 35,000 barrels daily by June 2019.

Importantly, the completion of critical pipeline infrastructure in northern Colombia will increase the volume of natural gas that Canacol can pump to crucial local energy markets. That should see a notable uptick in sales volumes further bolstering the driller's earnings.

Solid exploration upside

Canacol's considerable drilling success, which is estimated to be at 80%, means that its production and reserves will continue to grow at a healthy clip. The company recently completed its Nelson 13 development well located on the Esperanza block in the Lower Magdalena Valley basin, where it encountered 266 feet of net gas pay. This is the thickest formation of gas that Canacol has found on any of its blocks in the basin.

Canacol has also allocated US$119 million for its 2019 capital budget, which will be funded from existing cash and cash flow generated by operations during the year. Of that, US$50 million has been allocated to fund the drilling of five exploration and three development wells, which, based on Canacol's drilling success rate as well as the quality of its properties, bodes well for further discoveries and reserves growth.

While these attributes — along with a robust balance sheet and considerable liquidity, including US$53 million in cash at the end of the third quarter — bode well for Canacol's outlook, it is its ability to lock in higher-than-market prices for the natural gas it sells, which makes it a highly appealing investment.

Why buy Canacol?

Colombia, which was once self-sufficient, is suffering from a natural gas shortage that is so severe that it was forced to start sustained imports of liquid natural gas (LNG) in 2017. Growing demand, declining production from mature gas fields, and a dearth of new major natural gas discoveries are all responsible for triggering an expanding shortage of the fuel. This is being magnified by the crisis in Venezuela, including the implosion of that nation's oil industry and deteriorating political relations between the two countries, because Colombia's neighbour by mid-2017 was responsible for around 78% of all natural gas imports.

Those expanding supply constraints mean that Canacol has been able to lock in very favourable pricing for the natural gas that it sells. For 2019, it estimates it will receive US$4.63 per MMBTU, which is 77% greater than the benchmark North American market price of US$2.62 and more than double the Canadian AECO price of US$1.46 per MMBTU. This gives it a handy financial advantage over North American natural gas producers and, when coupled with rising production, will give its earnings a healthy lift.

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