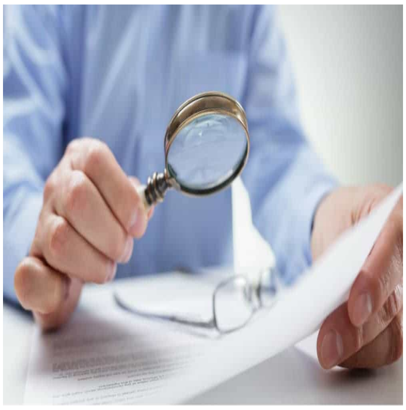

Is This Natural Gas Driller Poised to Rally Higher?

Description

Investing in Canadian natural gas producers has become unappealing in recent months. Not only has natural gas weakened sharply since reaching a multi-year high of over US$4.60 per million British thermal units (MMBTU), but the discount applied to Canadian AECO pricing remains significant. That is sharply impacting the profitability of Canadian natural gas producers, forcing some to shutter uneconomic operations and causing many to operate at a loss.

Those issues, however, shouldn't deter opportunistic investments in low-cost operators that own and operate high-quality assets. One such company is intermediate natural gas producer **Birchcliffe Energy** (TSX:BIR). While the benchmark Henry Hub natural gas price has lost 20% since the start of 2019, Birchcliffe's stock has climbed by 6%, buoyed by firmer oil and signs that it is successfully unlocking value for investors.

Quality liquids-rich assets

The driller is focused on the Peace River Arch and Montney oil and natural gas plays. Birchcliffe's acreage holds net reserves of 848 million barrels of oil equivalent with a productive life of 37 years. Those reserves are 97% weighted to natural gas and natural gas liquids. They have an after-tax net present value of $4 billion, or $15 per share, which is roughly six times greater than Birchcliffe's market price. This highlights the considerable potential upside that exists for investors, although it is important to note that a large portion of those reserves are undeveloped, and there is no guarantee that they will prove economic to bring to production.

Birchcliffe has been able to grow its production at a solid clip**,** seeing third-quarter 2018 output rise by 22% year over year to 739,331 barrels of oil equivalent daily. That hydrocarbon output was 20% weighted to oil and natural gas liquids.

The driller is a low-cost operator and is focused on controlling costs. For the third quarter 2018, operating expenses per barrel of oil equivalent produced fell by 19% year over year to $3.45. That reduction in costs coupled with higher oil prices saw Birchcliffe report that its third-quarter operating netback had risen by 18% compared to a year earlier to $13.03 per barrel of oil equivalent produced.

This — along with an additional 18% reduction in general and administrative expenses as well as lower interest expense, which fell by 14% for the quarter — will further boost Birchcliffe's profitability.

That means it is equipped to weather the latest oil price collapse and the prolonged slump in natural gas prices.

Birchcliffe's production will continue to grow. It agreed to purchase 15 net sections of land in the Pouce Coupe located in the Montney and contiguous to existing properties. That deal, which is expected to close in early 2019, will initially add 700 barrels of oil equivalent daily to Birchcliffe's production, while bolstering its drilling inventory. The company believes that the land is liquids rich, which means it should ultimately boost Birchcliffe's condensate and natural gas liquids reserves as well as production. The company also brought its 100%-owned natural gas processing plant in Pouce Coupe online during the third quarter, enhancing its processing capability.

These developments will work together to expand Birchcliffe's petroleum reserves and production, thereby bolstering its profitability and ultimately its market price.

For 2019, despite project production remaining flat compared to 2018, Birchcliffe expects to generate $135 million in free funds flow, which it anticipates using to fund its drilling program and reduce debt.

Is it time to buy Birchcliffe?

Weaker natural gas prices and the poor outlook for fuel, coupled with the ongoing wide differential between Canadian AECO pricing and the North American Henry Hub benchmark, don't bode well for natural gas producers operating in Canada.

Nonetheless, Birchcliffe's latest acquisition, improved processing infrastructure, and falling costs will boost profitability and earnings. This will be enhanced by the improved outlook for oil with analysts tipping that the North American benchmark West Texas Intermediate will rally to as high as US$60 a barrel during 2019. For these reasons, it is easy to see Birchcliffe's stock appreciating over coming months, making it an attractive contrarian play on natural gas.

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