Cenovus Energy Inc. (TSX:CVE) Remains a Risky and Unattractive Investment

Description

Beaten-down oil sands producer **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) has gained a whopping 26% for the year to date, outstripping the North American oil benchmark West Texas Intermediate (WTI), which has gained 20%. A swathe of pundits are claiming that Cenovus still appears undervalued and will move higher over the remainder of 2019.

Risks abound

While higher oil bodes well for the energy patch and Canada's oil sands producers, of which Cenovus is the third largest, there are still several headwinds for the company. Key among them is the lack of pipeline exit capacity, which caused the price of Canadian heavy crude Western Canadian Select (WCS) to plummet to record lows in November 2018 despite WTI trading at over US$70 a barrel.

After lobbying from Cenovus and **Canadian Natural Resources Ltd.,** the Government of Alberta introduced mandatory production cuts that immediately caused Canadian crude prices to rally substantially. The gains were in fact so significant that it has become uneconomic to ship bitumen by rail, sparking considerable criticism regarding the cuts from **Imperial Oil Ltd.** and **Suncor Energy Inc.**. This forced Edmonton to dial down the cuts by 75,000 barrels daily for February and March 2019 from the 325,000 barrels introduced in January.

While Alberta's government has considered longer-term solutions that it hopes will buoy Canadian oil prices once the cuts start to be phased out during the second half of 2019 when **Enbridge Inc.'s** Line 3 Replacement comes online, none of them address the core issue. Many of those solutions, such as boosting Alberta's refining capacity, simply kick the can further down the oil value chain without tackling the crux of the problem which is a lack of transportation capacity that is preventing Canadian oil from reaching crucial U.S. refining markets.

Even Edmonton's plans to bolster investment in rail infrastructure and rolling stock won't resolve the dilemma because of a fundamental inability to transport substantially larger volumes of crude because of an already stretched to capacity rail network. The higher costs associated with oil transportation by rail are also an issue as witnessed by Imperial Oil's moves to wind down the volume of oil it is transporting by rail to nearly zero for February.

Long-term outlook remains poor

For these reasons, it's unlikely that Cenovus will be able to fully capitalize on its ability to grow production over the long term. which saw 2018 production from continuing operations expand by 32% year over year to 483,458 barrels daily. This is particularly the case when it is considered that 75% of its oil production is comprised of bitumen and it is the heavy oil benchmark WCS that's most vulnerable to wider price differentials to WTI.

Another 18% of Cenovus' petroleum output is composed of natural gas, which despite benefiting from recent short-term price spikes because of unseasonably cold weather is suffering a similar dilemma. The Canadian AECO natural gas price is trading at US$0.91 discount per million British thermal units (MMBtu) to the benchmark Henry Hub price.

Given its 2018 results, this is having a significant impact on the profitability of Cenovus' operations. Despite WTI averaging US$64.77 per barrel during the year, or 27% greater than the 2017 average, Cenovus' average realized price per barrel of oil equivalent sold was $35.74, or 3% lower than a year earlier. That means Cenovus' initiatives to significantly reduce costs, which saw 2018 operating expenses fall by 9% year over year, are a pivotal means of driving long-term profitability. Ultimately, however, there's only so much fat that can be trimmed or efficiencies implemented before higher prices are required to bolster margins.

While Edmonton's production cuts will sustain WCS prices at profitable levels for the short term, the fallout they have triggered has made them even more unpopular among industry participants.

As a result, it is highly unlikely they will remain in play over the long-term or be revisited should price differentials widen significantly in the future. This means that Cenovus will once again face similar issues, including poor margins and the risk of producing heavy oil at a loss once the cuts wind down later this year. For these reasons, Cenovus is an unattractive investment, particularly in comparison to Suncor and Imperial Oil, which, because of their significant refining operations, were profiting from the wide price differential between WCS and WTI.

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