Cenovus Energy Inc (TSX:CVE) Has a Hidden $1.6 Billion Bomb on its Balance Sheet

Description

In many ways, **Cenovus Energy** (TSX:CVE)(NYSE:CVE) is in a death spiral.

Last year, the company posted a loss of $2 billion, despite revenues hitting a multi-year high. Cash levels fell to just $571 million, down from their 2015 peak of $3 billion. Long-term debt is now at $6.2 billion — a 20% rise from 2015 levels.

Worse yet, there could be a $1.6 billion bomb waiting to explode, hidden within the company's balance sheet.

Cenovus made one huge bet

In 2017, Cenovus president and CEO Brian Ferguson announced that he would be leaving the company. The timing was curious considering he had just put into motion the company's largest transformation in history.

Earlier in the year, Cenovus announced that it would be acquiring the 50% stake in the Foster Creek Christina Lake partnership owned by **ConocoPhillips**. Cenovus owned the other half of the joint venture. The deal would also include the majority of ConocoPhillips's Deep Basin conventional assets in Alberta and British Columbia.

While the deal was reportedly valued at $17.7 billion, including both cash and stock, Cenovus would also be on the hook for five years of "uncapped contingent payments, triggered when Western Canada Select crude prices exceed $52 per barrel."

To fund the deal, Cenovus spent 80% of its cash holdings, issued 187.5 million shares, and likely tapped some of its credit lines. Then-CEO Brian Ferguson regarded the purchase as a "unique opportunity to take full control of our oil sands assets."

It was a huge bet that would impact the company for years to come. In hindsight, the deal was disastrous.

Still paying for past sins

In May of 2017, Cenovus completed its purchase of ConocoPhillips's assets. Afterward, ConocoPhillips actually owned 16.9% of Cenovus stemming from its share issuance, but this stake is expected to be wound down over time.

To fund the massive purchase price, former CEO Brian Ferguson reiterated that the company "would sell some of the newly acquired assets after the deal." Unfortunately, the company was entering a terrible period for divesting assets.

The first domino to fall was the revelation that both **Royal Dutch Shell** and ConocoPhillips would sell their multi-billion-dollar stakes in Canadian oil sands producers, including Cenovus. This put a huge damper on the company's share price as huge lots of sell orders flooded the market.

Forced selling put Cenovus in a difficult position considering it still planned to sell $4 billion in assets that year. Asset prices were pressured as investors took cues from Royal Dutch Shell and ConocoPhillips, both of which were abandoning the space.

"Everybody knows they are selling and that they have a weak hand," summarized John Stephenson, the head of Stephenson & Co. Capital Management. His take was spot on.

Cenovus needed to free up cash to pay down a $3.6 billion bridge facility that was used to fund the acquisition. Competitors knew that it needed to sell assets fast.

After the deal, Cenovus booked a goodwill charge of more than $1 billion. Today, it has goodwill assets worth $1.6 billion — at least according to its balance sheet. If oil prices don't improve quickly, this financial asset is doomed to be written off, erasing multiple years' worth of profits.

Cenovus is a mess

After the acquisition, Cenovus now has a breakeven oil price of US$50 per barrel or higher. That puts it towards the high end of the cost curve just as oil markets turn bearish.

Long term, oil sands remain a terrible investment. In fact, some competitors may see their shares go to $0 over the next decade. Cenovus shares are beaten down for a good reason. Let other investors take a risk on this stock.

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Date
2025/08/24
Date Created
2019/03/14
Author
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