This Dirt-Cheap Energy Stock Offers 500% Upside Potential

Description

After five years of decline, it's easy to understand why most investors have written off the energy sector. Many think the space is doomed to continue shrinking, slowly driven into oblivion by self-driving cars, aggressive plastic recycling, and a general move away from disposable products.

But, as the old saying goes, it's darkest right before the dawn. Oil is due for a nice recovery, precisely because nobody thinks so.

Canada's largest energy producers have spent the last five years reinventing themselves as well. Gone are the bloated balance sheets and high-cost production. These weaker players have either been acquired or bankrupted. What's left are lean producers poised to rocket higher when crude oil recovers.

Some players are incredibly cheap today based on very reasonable expectations for 2019. Let's take a look at one producer, **MEG Energy Inc.** (TSX:MEG), which trades at less than four times expected free cash flow at writing. No, that's not a typo; this stock really is that cheap.

The skinny

One of the big advantages of harvesting energy from Alberta's oil sands is most of the investment is made up front, getting the site prepared for a large-scale mining operation. Ongoing costs are minimal, especially when compared to conventional oil producers.

MEG's oil sands leases in the southern Athabasca region cover some 2,300 square kilometers, with probable reserves of more than three billion barrels of oil. The company produces approximately 100,000 barrels of oil per day currently, giving it a 40+ year reserve life at today's depletion rates. It has plans to increase daily production by approximately 60% over the next 3-5 years depending on market conditions and regulatory approvals.

Assuming that the price of crude oil averages US$60 per barrel in 2019, MEG is poised to produce some serious free cash flow. One analyst pegs that number at $445 million. The company has a current market cap of $1.6 billion, giving the company a price-to-free cash flow ratio of 3.6. In other words, MEG has a free cash flow yield of 27.8%.

MEG also trades at a serious discount to its stated book value. The stock currently sits at just 41% of book value. This is a massive discount, even in a sector as cheap as the energy space.

The company plans to spend every nickel in free cash flow on debt reduction. This will save it interest costs, which will further promote cash flow growth.

Why so cheap?

It turns out I'm not the only person who realized how cheap MEG stock is. **Husky Energy** noticed about a year ago, which culminated in the company making a takeover offer at $11 per share back in October 2018.

The deal fell apart a few months later for a number of reasons. MEG's management was vocal in their opposition to the potential takeover, saying the offer didn't fully value the company. The Alberta government also implemented mandatory production cuts for energy companies operating in the province. And part of Husky's bid would have paid for MEG with new Husky shares, which declined significantly after the offer was initially made.

One of the reasons why MEG shares are so cheap today is because investors didn't like the way management handled the hostile Husky bid. The stock is being punished for these perceived sins, which is great news for long-term value investors.

Finally, MEG could unlock shareholder value by licensing its Hi-Q partial upgrading technology to other oil sands operators — a process that has the potential to transport bitumen through pipelines without needing any dilution.

The bottom line

Canada's stock market is filled with cheap energy companies, but MEG Energy might be the most inexpensive of all. The stock has significant upside potential. Investors should remember that shares flirted with $25 each back in 2015. If crude heads higher, investors could easily see similar prices again, which would be close to a 500% return from today's prices.

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nelsonpsmith